Harmonisation of Cost Elements of the Annual Percentage Rate of Charge, APR

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presented by

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Summary and Recommendations

1. Regarding the existing harmonisation of the APR in the Member States, little action seems to be necessary. The law in all countries mainly refers to the Directive using its wording and its exemptions. A minimum standard of APR disclosure has been reached Europe-wide. Although there are quite important differences in the cost structure of consumer credit contracts as well as in the wording of the national legislation, (1) these differences are mostly not specific for one country, even occurring between different offers inside the same country and (2) there seems to be a consensus in practice among providers about a minimum standard. Accordingly, in all Member States all payments concerning services which are directly connected to the credit are included. Such services concern:
   - Interest;
   - administration fees; and
   - brokers’ fees.

   As to all other fees the practice assumes that the exemptions of the Directive apply. This is especially the case for all:
   - insurance fees irrespective of the purpose of the insurance;
   - fees for bank accounts and cards; and
   - notary fees and postage.

2. There are three services to which the Directive seems to be applied differently in Member States:
   - Endowment life insurance credit where, despite the fact that the consumer has no choice and is obliged by the contract itself to take the hidden payment protection insurance - Germany and the UK seem to exclude such premiums irrespective of the form of its appearance. This seems to be in clear contradiction to the Directive. But the exclusion for consumer credit products is not clear because the administrative rules in the UK and Germany where apparently made with regard to mortgage loans, although this is not explicitly stated in the rule itself. Further, more endowment life insurance credit as consumer credit has been ruled by German courts to be a misleading product leading to compensatory damages being awarded to a consumer if she can prove there were less costly products available on the market. Accordingly the practical importance of such products in consumer credit is minimal.

   - Austria and France are the only countries where taxes are imposed for the extension of credit, but they treat it differently with respect to APR. In the author’s view, the Directive treats such costs as „costs of the credit“ because they are inseparably linked to the credit and make a product comparatively more expensive, without offering additional services - if this product is purchased in a country where such extra charges are imposed. So the purpose of the Directive - to make offers comparable in different Member States - is not met if such specific charges are not included. But again, the taxes are not so important that major effects from this exclusion can be expected on the market.
• The finance charge for financing Payment Protection Insurance premiums is partly counted as part of the credit cost, in part it remains outside. Assuming that the Directive excludes PPI premiums from the APR but not such finance charges which are obligatory and specific for insurance products, those banks which omit the cost seem clearly to contravene the Directive, as well as national law.

3. The above mentioned differences would, with regard to the standards in all Member States, have been eliminated by the courts if those courts were to have sufficient chances to monitor the application of the Directive. In fact, all countries provide little or no case law on this matter which has to do with a lack of effective sanctions and too little financial incentive for a consumer to sue a creditor on the grounds of APR disclosure.

4. The purpose of the Directive is not only harmonisation but also consumer protection. The goals of the APR disclosure rules may be defined as follows:

• Transparency to compare different credit products available on the market in order to exercise a rational choice (rational choice); and
• Disclosure of especially high costs in consumer credit burdening low-income consumers with respect to their poor bargaining power, in order to stigmatise such providers and, for some countries, to apply legal remedies deriving from rate ceilings and usury legislation (prevention of usury).

5. In the context of a high standard of consumer protection as demanded in Art. 3 alinea 1 letter t of the Treaty as well as in the context of the effective achievement of the purpose of the regulation, as stated in Art. 14 of the Directive, the factual situation in the Member States is quite unsatisfactory. In practice up to 30% of standard costs a consumer will pay in a consumer credit agreement are not represented in the APR. The exemptions in the Directive concerning products (insurance, bank account fees) have led to their total exclusion. The sophisticated restrictions on the application of these exemptions in the Directive itself have no practical effect. Accordingly, this regulation has failed to achieve its goals. The effects of this situation are visible in the following phenomena which seem to be engendered and furthered by the Directive’s own definition of exemptions:

• Payment Protection Insurance has developed into a general outsourcing of credit risks at the cost of the consumer. The products are disadvantageous, extremely costly and applied inappropriately and to that extent, far too often. It seems as if these exclusively linked products have become a main source of additional income for credit providers, escaping competitive forces;
• Specifically charged bank account fees are not yet an economic problem but with the spread of credit card credit - which is no longer linked to overdraft credit on a current account but provides own credit facilities - increasingly fees concerning credit are allocated with payment devices and thus escape APR-legislation;
• Combined, endowment products which divert repayments of the credit into a form of savings agreement with lower interest returns in the savings than is charged in the credit are increasing. Products like „endowment capital life credit“, „secured credit cards“, instalment or overdraft credit where assets are requested as a security are already on the market, undermining transparency and rational choice as well as usury legislation.
• Zero interest credit is extended by banks owned by automobile companies as an incentive to buy cars. In fact such low interest rates are paid by a denial of advantages that ordinary cash purchasers get.

6. There are no mathematical arguments which may be raised for the inclusion or exclusion of connected services and costs. The mathematical formula, where \( K_1 = K_0 \times (1 + i)^t \) is sufficient to calculate all kinds of credit and other services - with the help of spreadsheet software and iterations - if the payments of the consumer and the provider as well as the time when these payments are effected (payment flow calculation) are known. Sophisticated formulae are unnecessary and mostly only applicable to specific standardised credit contracts, tending to hide normative assumptions in mathematical language. The trend towards individualised products necessitates payment flow calculations where each single payment may be defined separately, excluding all kinds of mathematical formulae.

7. The main reason for the lack of effectiveness of the Directive lies in the complicated and inhomogeneous structure of the Directive’s wording itself - which is mostly mirrored in the national legislation. The legislative problems of the Directive as far as cost elements are concerned are as follows:

• The Directive contains two different definitions of the APR which have a different focus and approach. The first definition in Art. 1 uses an outdated and mathematically inconsistent concept of credit prices as „cost“ elements instead of referring to the payments of a credit relationship which underlie the calculation of the APR;
• The Directive gives no general definition of the link which has to be established between credit services and additional services in order to include those payments into the APR calculation; besides the versions in different languages are inconsistent with each other;
• Its approach must be divined from the examples - which is difficult to do on account of certain inconsistencies:
  • The definition partly refers to a description of products (insurance, bank accounts), partly to general cost structures (cost of the credit);
  • In some places, economic language („cost of the credit, reasonable freedom of choice“, „abnormally high“) is used to ensure that, as stated in Art. 14, the „Directive is not circumvented as a result of the way in which agreements are formulated“ while in contradiction to this in the most important parts legal language („commitments“; „imposed by the creditor“; „obliged to pay“) is used, giving providers the opportunity to „define“ in the contract that there are no links;
• The Directive applies a problematic structure to formulate examples of its application:
  • The relationship between general definitions and specific examples is unclear in so far as some examples seem to contradict the general principles containing their own general principles (legal versus economic links);
  • The Directive apparently only regulates exemptions. Accordingly, it gives the impression that exemptions are the most important concern of the Directive. In fact most of the text of the exemptions concerns „exemptions of exemptions“ and should, in the tradition of
transparent legislation, be regulated as positive examples instead of double-negative examples; and

- The exemptions mix two approaches: (1) A product approach exempting insurance and bank account fees and (2) a functional approach exempting costs which occur in comparison to cash purchases, as well as cost elements linked to default.

8. In light of the requirements of consumer protection, it is submitted that the Directive should be reformulated and clarified. Effective regulation would require:

- the removal of the first, unnecessary definition of the APR in Art. 1 d);
- the insertion of a general definition of “linked transactions” which is similar to the approach already used in Art. 11 of the Directive to safeguard consumer rights in linked transactions of purchases and credit. This definition has to include the criteria as well as the indicators of services whose payment flow will be included into APR calculation;
- giving a list of positive and negative examples which do not replace the general principles but rather illustrate their application;

9. The following text could replace the present wording of the Directive - and by reintroducing the regulation of Article 1A completely into Art. 1, restore the internal logic of the Directive and make it easier to understand:

Art. 1A and Article 1 (2), points (d) and (e) shall be replaced by the following:

Art. 1

“(d) „total cost of the credit to the consumer“ means all the costs, including interest and other charges, which the consumer has to pay for the services linked to the credit“

(e) The „annual percentage rate of charge“ is the equivalent, on an annual basis, to the present value of all payments (loans, repayments and charges), future or existing, which concern either the credit or the services linked to the credit calculated in accordance with the mathematical formula set out in Annex II. Four examples of the method of calculation are given in Annex III by way of illustration.

(f) A service and any payment for such service is „linked to the credit“ if it forms an “economic unity” with the credit. An “economic unity” exists where the service or payment supports general credit related functions such as, but not limited to the marketing and take-up of the credit, the supply of information for credit scoring and advice, the administration of the credit and re-payment schedule and the allocation and administration of risk. The following independent criteria may help to identify services linked to the credit:

(i) The service is offered at the same time as the credit is extended through the provider of the credit. The term (duration) and conditions of the service and/or any payment for such service is related to the credit and the service is not generally available independently on the market
in this form. Payment, insurance and investment services are not linked to the credit where they have value to the consumer independently from the credit agreement;

(ii) The consumer has no reasonable choice between products offered by the provider, especially where such obligations are entered into before or at the time the credit agreement comes into force;

(iii) The service or equivalent services are available at a significantly lower cost on the open market; and

(iv) The consumer would have no use of such a service if the financed good were purchased with cash.

A list of examples is given in Annex IV

The following examples shall be inserted as Annex 4

(a) Examples of linked services:

(i) credit brokerage;
(ii) administration of the credit;
(iii) notary services for debt collection;
(iv) provision of information for credit scoring procedures;
(v) insurance protecting solely the repayment of the credit;
(vi) bank account fees for accounts which have the sole purpose of facilitating the payment of the credit; and
(vii) financial service packages (endowment agreements) where the repayment of the credit is deferred for the purpose of using a parallel investment-, savings- or life insurance policy for the eventual repayment of the total or part of the debt.
(viii) Advantages that have been denied in financed purchase agreements which other consumers received with cash with the same dealer

(b) Examples of unlinked services:

(i) services establishing and securing guarantees for the credit (eg. motor vehicle insurance, notary fees for mortgages);
(ii) membership of associations and groups which give access to services linked to special or preferential credit but are otherwise unconnected with it;
(iii) bank account services and payment devices such as payment and credit cards that provide a standard set of general payment services;

10. Consumer Organisations in Member States should be equipped with a computer programme that provides input facilities and explanation for all cost items to be included, combines them into a correctly calculated Annual Percentage Rate of Charge and stores the credit data used for such calculations for later evaluation in order to monitor the practical application of the Directive in all Member States.

11. Information about cost in default situations is not significant to consumer choice. The present way of some countries of limiting default charges is the correct way and should be followed. Special provision on the harmonisation of these measures together with measures to harmonise personal bankruptcy are necessary. The APR should in any event not be affected by this directly.
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I. Aims of the Study

A. The Purpose and Object of the Study

1. Purpose

This report seeks to inform the Commission on the preparation of its position concerning further harmonisation of the inclusion of cost elements establishing the total cost of credit to the consumer expressed as an Annual Percentage Rate of Charge (APR).


"Job Description"

Harmonisation of Cost Elements of the Annual Percentage Rate of Charge, APR

At the Consumer Council on 10 April 1997, the Council reached a Common Position on the Commission draft proposal for a Directive concerning consumer credit: proposal for a single, Community mathematical formula for calculating the total cost of credit, the Annual Percentage Rate of charge, APR; the Common Position was formally adopted on 7 July this year.

The Common Position includes the following recital:

"Whereas it is appropriate to study without delay to what extent a further degree of harmonisation of the cost elements of consumer credit is necessary in order to put the European consumer in a position to make a better comparison between the actual percentage rates of charges offered by institutions in the various Member States, thereby ensuring harmonious functioning of the internal market."

DG XXIV decided to pursue a two-pronged approach on the study decided by the Council:

1. convocation of a group of (national) experts; and 2. commissioning a study to prepare its own position.

To carry out the study foreseen as the second element, the Commission requires the assistance of an expert in theoretical financial mathematics. The contractor will be requested to:

Update the information on the situation concerning cost elements in Member States, cf. section IV of the "Report on the Operation of Directive 90/g8", document COM (96) 79 final: Is the description of the situation, legislative and otherwise, in Member States found in this Report still valid? If not, have there been significant developments, i.e. developments that lead to different or modified conclusions than the ones drawn on the basis of the information provided by Report and quoted above?
• Develop a theoretical approach to the principle of "information on total cost of a credit": role of and limits to the APR, complementary instruments, alternative options.

• Present the result of these two actions in a report, with all appropriate documentation.

In the context of agreed harmonisation of the mathematical formula used to calculate APRs in the Member States, the Council has accordingly required the Commission to obtain this independent report which will examine problems with the application of the Directive in practical and theoretical terms rather than limiting scrutiny to effective Member State transposition. It will provide a summary of Member State submissions on this matter.

Essentially, the report’s focus will be to bring out tensions present in the legislation due to the inherent paradox of aiming for harmonisation while allowing Member States to impose more stringent consumer protection measures - for example, both by including additional cost elements or interpreting the Directive as anti-usury legislation.

2. The Object: Credit and the Cost of Credit

Commercial consumer credit has essentially three elements:

• amount of credit - capital which the consumer can use as purchasing power;

• term - time during which the consumer can use this power; and

• charges - which the consumer has to pay in connection with the credit.

<table>
<thead>
<tr>
<th>1. Principal (Credit)</th>
<th>10,000.--</th>
</tr>
</thead>
<tbody>
<tr>
<td>2. Date of Advancement</td>
<td>01.01.1998</td>
</tr>
<tr>
<td>4. Instalment</td>
<td>5,376.97</td>
</tr>
<tr>
<td>5. APR</td>
<td>10.29 % p.a.</td>
</tr>
</tbody>
</table>

The above data can straightforwardly be categorised into three elements because items 2 and 3 indicate the time period for the credit with one advance of 10,000.- ECU for a term of 6 months and a second advance for 5,122.40 ECU (plus interest, minus instalment) for a further 6 months while items 4 and 5 represent the cost element and are interchangeable. If the two instalments together amount to 10,759 ECU then the total cost of the credit is 759 ECU.
In the following graph the whole area represents the amount repayable by the borrower. It consists of the capital and the costs - which should decrease with the repayment of the principal.

**Graph 1 Credit Amount**

The APR calculation essentially illustrates how cost, time and credit may be presented together. Thus, the interest rate APR is defined as the relation of cost to the product of time and capital indicating that these costs represent two factors, namely the amount of purchasing power received and the time during which this purchasing power may be exercised.

In theory, the calculation of one interest rate to represent the total cost of a credit is very simple. As all credit contracts expire on one day - on which the creditor will usually present a bill containing the remainder of what will have to be paid by the borrower - the costs seem to be sufficiently clear.

The total cost of credit is the difference between what the borrower received and what she has had to pay during the term of the credit agreement. If, according to the cash flow development of the credit the outstanding amount is defined for each time period the APR is easy to calculate.¹

In principle a borrower should not have to pay regard to how credit costs are calculated and denominated. It would clearly be preferable to receive a repayment schedule from which time and cost would be easy to ascertain.

But as competition requires comparison, creditors distinguish between fees, interest and prices. Fees normally represent a service, interest a charge for credit and (not so strictly speaking) a price, the purchase of a good. Either for their own internal controls and price calculation or for the purpose of explaining the total cost to the borrower, credit providers distribute the costs of credit into both fees and interest.

¹ see below The Tools of Analysis: Mathematical, Legal and Economic Approaches p. 13
This separation has nothing to do with the APR calculation. It is only a method of setting prices for credit.

There are several incentives to increase the number and variations of such fees to the detriment of an inclusive interest rate:

1. Consumers focus mostly on the „main price“ of a credit, that is the nominal interest rate, and are not so aware of the total burden of cost if cost elements are enumerated separately (a phenomenon which is well known in, for example, car dealing - where the quoted headline price is often far below the true price when „extras“ have to be added)

2. Fees may arise at any time during the life span of a credit agreement which allows the individual adaptation of instalments and how the credit is perceived.

3. Some fees refer to services the creditor receives from third parties which may either pay a commission or facilitate a credit extension for the creditor but have to be paid out of the revenue earned with the instant credit extension.

4. Some fees offer, or at least seem to offer a choice for some or all consumers to make savings on them - so that their separate indication helps to evaluate the amount that may be saved.

5. Fees often serve as a focus for bargaining, giving room for individually adapted incentives without touching on the general interest rate.

6. In the case of early repayment or credit cancellation, fees that are linked to special services may be withheld from any refund because they are already consumed while interest for future capital use has to be refunded.

7. Most fees are front loaded which gives the creditor the additional opportunity to extend more credit than requested, for example, an insurance premium which has to be paid in advance which actually means that it will be financed through an additional amount of credit.

Out of the number of fees connected with a credit contract the Directive has tried to identify those which are needed to be included in the APR calculation for comparison with other credit offers on the market. This approach assumes that competition requires choice and choice needs comparability. As the APR excludes those elements which normally make credit incomparable (time and outstanding capital) the question remains: Which cost elements related to a credit advance should be seen as part of „the cost of the credit“?

This again assumes, at least to some extent, that a certain amount of credit extended for a certain time is equal to another credit extension if the aggregate measurements of cost come to the same result. This assumption is the basic problem with cost elements because, in competitive markets, those undertakings which are able too claim their product is unique and only accessible through a particular distributor have the best position in the market. As credit extension has long since left the realm of
Harmonisation of Cost Elements of the Annual Percentage Rate of Charge (APR)

„lending money“ towards “providing financial services” there is reason to assume that no credit from one supplier is actually comparable to the product of another supplier.

This is why comparison needs a normative assumption - what should or should not be treated as equal. If legislators (or a consumer watchdog magazine which would have to solve the same problem) define what they think should be a balanced choice between two credit products they have only one criteria of importance: consumer behaviour itself. Accordingly, the question underlying the whole discussion on cost elements is not a question of which cost elements should be included but what types of credit are still be compared to standard minimum credit.

Some Member State legislation and indirectly - by exemptions - the Directive has provided a list of fees that are conceivable. This list is far from exhaustive because such legislation naturally engenders new incentives in the market to invent other cost elements. The situation is analogous to misleading advertisements where the more cases that are covered by legislation, the more sophisticated misleading advertising becomes.

The following table attempts to schematise the different cost elements. The first lines, where highlighted, indicate whether the fees are taken at the beginning of the credit and whether they are financed in such a form that they are either added to the requested line of credit or subtracted from it. The third line shows whether the fee has to be (partly) delivered to a third party – such as an insurer or a notary - and the last line, where highlighted, gives a rough estimation of whether these elements are included in the APR calculation and a rough estimation of the percentage to what part of the total cost of the credit they may amount in order to show their importance.
### Table 1: Overview of Cost Elements

<table>
<thead>
<tr>
<th>Fees for</th>
<th>Up-front</th>
<th>Financed</th>
<th>Third Party</th>
<th>Incl. in APR</th>
</tr>
</thead>
<tbody>
<tr>
<td>Setting-up and administrative costs</td>
<td></td>
<td></td>
<td></td>
<td>2%</td>
</tr>
<tr>
<td>Broker</td>
<td></td>
<td></td>
<td></td>
<td>5%</td>
</tr>
<tr>
<td>Guarantees</td>
<td></td>
<td></td>
<td></td>
<td>1%</td>
</tr>
<tr>
<td>Authentication before notary</td>
<td></td>
<td></td>
<td></td>
<td>0.2%</td>
</tr>
<tr>
<td>Life insurance</td>
<td></td>
<td></td>
<td></td>
<td>-&gt;20%</td>
</tr>
<tr>
<td>Disablement Insurance</td>
<td></td>
<td></td>
<td></td>
<td>-&gt;20%</td>
</tr>
<tr>
<td>Unemployment Insurance</td>
<td></td>
<td></td>
<td></td>
<td>-&gt;30%</td>
</tr>
<tr>
<td>Risk Insurance for Loss, Theft of Securing Goods</td>
<td></td>
<td></td>
<td></td>
<td>1%</td>
</tr>
<tr>
<td>Credit Life Insurance</td>
<td></td>
<td></td>
<td></td>
<td>-&gt;30%</td>
</tr>
<tr>
<td>Stamp duty</td>
<td></td>
<td></td>
<td></td>
<td>0.1%</td>
</tr>
<tr>
<td>Overdraft charges</td>
<td></td>
<td></td>
<td></td>
<td>4%</td>
</tr>
<tr>
<td>Continuing line of credit</td>
<td></td>
<td></td>
<td></td>
<td>0.1%</td>
</tr>
<tr>
<td>Authorisation of credit</td>
<td></td>
<td></td>
<td></td>
<td>1%</td>
</tr>
<tr>
<td>Confirmation</td>
<td></td>
<td></td>
<td></td>
<td>0.5%</td>
</tr>
<tr>
<td>Providing an account statement</td>
<td></td>
<td></td>
<td></td>
<td>0.5%</td>
</tr>
<tr>
<td>Endorsements</td>
<td></td>
<td></td>
<td></td>
<td>0.5%</td>
</tr>
<tr>
<td>Bank account</td>
<td></td>
<td></td>
<td></td>
<td>0.5%</td>
</tr>
<tr>
<td>Membership for risk groups</td>
<td></td>
<td></td>
<td></td>
<td>1%</td>
</tr>
<tr>
<td>Credit cards</td>
<td></td>
<td></td>
<td></td>
<td>0.4%</td>
</tr>
<tr>
<td>Transmission of funds</td>
<td></td>
<td></td>
<td></td>
<td>0.1%</td>
</tr>
<tr>
<td>Not using the credit</td>
<td></td>
<td></td>
<td></td>
<td>0.25%</td>
</tr>
<tr>
<td>Waiting</td>
<td></td>
<td></td>
<td></td>
<td>0.25%</td>
</tr>
<tr>
<td>Early repayment/cancellation</td>
<td></td>
<td></td>
<td></td>
<td>20%</td>
</tr>
<tr>
<td>Service charges</td>
<td></td>
<td></td>
<td></td>
<td>1%</td>
</tr>
<tr>
<td>Postage</td>
<td></td>
<td></td>
<td></td>
<td>0.1%</td>
</tr>
</tbody>
</table>
B. The Discussion on Cost Elements

The harmonisation of general conditions governing consumer credit has been given priority in the EU, as stated in the preamble to the Directive. The original work prepared by the Commission on this matter envisaged an APR calculation which would be the same throughout the Community. The draft Directive sought to provide a comprehensive and uniform set of common rules throughout the Member States but the requirement for unanimity for Council decisions at that time altered these proposals, most significantly for our purposes in the form of Article 15, the \textit{clause minimale}. Until the time of writing, this has allowed Member States the flexibility to view the Directive as a floor to their consumer protection measures in this area.

1. Viewpoints at the Commission Level

Previous analyses of the operation of the Directive have generally concluded that such differences as do exist between different Member States do not necessitate further harmonisation.


The Directive was drafted following the EEC Programme for Consumer Protection and Information and the Commission desired a common approach to the calculation of the true cost of credit to the consumer.

With a view to securing promulgation by unanimity (prior to the Single European Act), the initial proposals were modified allowing Member States increased flexibility, particularly for our purposes in the method of calculation of the APR. At page 14 it is noted „Examination of inter-country differences shows that the Directive’s harmonisation impact has been limited“ while the Directive is considered to have given impetus to Member States towards consumer protection in this area.

\textit{In particular at page 17 it was noted -}

\begin{itemize}
\item \textsuperscript{2} A history of the Consumer Credit Directive is provided in the Seckelmann Report. We therefore only stress the question of the inclusion of cost elements into the Directive.
\item \textsuperscript{3} COM (95) 117 final p 13
\item \textsuperscript{4} COM (96) 79 final p 29
\item \textsuperscript{5} COM (95) 117 final „Report on the operation of Directive 87/102/EEC for the approximation of the laws, regulations and administrative provisions of the Member States concerning consumer credit“ p 1
\item \textsuperscript{6} op cit
\end{itemize}
As regards difficulties linked to the total cost of the credit, some problems have arisen with regard to the mandatory indication of the total cost in the case of credit agreements with modifiable terms, credit lines and financing in instalments. There have also been difficulties in relation to the effective rate of charge for advances on current accounts.

b) Report (Contract AO 2600 / 94 / 000101) by Professor Seckelmann 31 October 1995

In his Study on „Methods of Calculation, in the European Economic Area of the Annual Percentage Rate of Charge (APR)“ Professor Seckelmann provides a summary analysis of the question of ancillary items of charge.

We reproduce here a table from that report which gives a summary of the regulation on cost elements. This summary has not been approved by the present research - which would in any event conclude that the items are regulated in all Member States but that the form varies so much that a cross would have been made throughout.

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7 Final Report October 1995 Contract AO 2600 / 94 / 000101 p. 100
Table 2: Cost elements in the National Legislation - Findings of Professor Seckelmann

<table>
<thead>
<tr>
<th>State</th>
<th>legal basis/article in act / order refers to the regulations quoted in the analyses state by state</th>
<th>costs in case of default</th>
<th>costs with cash purchase</th>
<th>costs of transfer of funds</th>
<th>fees for membership</th>
<th>costs for insurance except PPI</th>
</tr>
</thead>
<tbody>
<tr>
<td>EU</td>
<td>1a.2.i-1a.2.v Directive</td>
<td>X</td>
<td>X</td>
<td>X</td>
<td>X</td>
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<tr>
<td>Belgium</td>
<td>2 Order 1992/2311</td>
<td>X</td>
<td>X</td>
<td>X</td>
<td>BE</td>
<td></td>
</tr>
<tr>
<td>Denmark</td>
<td>13 Act 1990/398</td>
<td>X</td>
<td>X</td>
<td>X</td>
<td>DA</td>
<td></td>
</tr>
<tr>
<td>Germany</td>
<td>4 price label Order</td>
<td>X</td>
<td>X</td>
<td>X</td>
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<td></td>
</tr>
<tr>
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<td>4.1.a Dec 1991 / 1-983</td>
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<td>X</td>
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<td>X</td>
<td></td>
</tr>
<tr>
<td>Spain</td>
<td>18 Act 1995/7</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>ES</td>
</tr>
<tr>
<td>France</td>
<td>L 313.1 Act 1993/949</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>FR</td>
</tr>
<tr>
<td>Ireland</td>
<td>10 1995</td>
<td>X</td>
<td>X</td>
<td>X</td>
<td>X</td>
<td></td>
</tr>
<tr>
<td>Italy</td>
<td>2.2-2.4 Order 8.7.92</td>
<td>X</td>
<td>X</td>
<td>X</td>
<td>X</td>
<td></td>
</tr>
<tr>
<td>Luxembourg</td>
<td>2 Order 26.8.93</td>
<td>X</td>
<td>X</td>
<td>X</td>
<td>X</td>
<td></td>
</tr>
<tr>
<td>Netherlands</td>
<td>34 Act 4.7.90</td>
<td>X</td>
<td>X</td>
<td>NL</td>
<td>NL</td>
<td>NL</td>
</tr>
<tr>
<td>Austria</td>
<td>33.8 Act 1993/532</td>
<td>X</td>
<td></td>
<td>X</td>
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<td>X</td>
</tr>
<tr>
<td>Portugal</td>
<td>4.5-4.6 Act 1991/359</td>
<td>X</td>
<td>X</td>
<td>X</td>
<td>X</td>
<td></td>
</tr>
<tr>
<td>Finland</td>
<td>ch 7.2+7.22 Act 1994/16</td>
<td></td>
<td></td>
<td>X</td>
<td>X</td>
<td>SF</td>
</tr>
<tr>
<td>Sweden</td>
<td>2 Act 1992/830</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>SV</td>
</tr>
<tr>
<td>United Kingdom</td>
<td>5.1 Order SI 1980/51</td>
<td>X</td>
<td>X</td>
<td>UK</td>
<td>X</td>
<td>UK</td>
</tr>
<tr>
<td>Iceland</td>
<td>7 Act 1994/121</td>
<td>X</td>
<td>X</td>
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<td>IC</td>
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<tr>
<td>Norway</td>
<td>6a.1 Act 1985/82</td>
<td>X</td>
<td>X</td>
<td>X</td>
<td>X</td>
<td>X</td>
</tr>
</tbody>
</table>

Professor Seckelmann notes variously:

„The EU Committee on Legal Affairs and Citizen’s Rights on 17 November 1988 pointed out, that without agreeing on a definitive list of which items are to be brought in to charge, apparently uniform effective interest rates could disguise significant differences. ... Only a few national regulations itemise such charges. “ (p100)

„The declared goal of the Member States to harmonise elements of income and cost and to include them all in the effective interest rate should be pursued with the additional goal of minimising the kind, number and amount of such charges.” (p147)
Harmonisation of Cost Elements of the Annual Percentage Rate of Charge (APR)

Having identified the problem of significant differences, this submitted approach of reigning in the market’s tendency to adapt itself around regulation may be interpreted in two ways; either drafting wider regulation to minimise the opportunities for credit providers to escape the scope of APR regulation or to be prescriptive about how credit providers run their business.

On p158 Professor Seckelmann comments further:

- „Considering all exceptions and exceptions from exceptions in Art. 1A.2 one may say that all items of charge to the borrower connected with a loan levied by third parties, e.g. notary or a state or local administration, are excluded from the ‘annual percentage rate’“...

- “… The combination of a loan with an insurance - except, perhaps with a rest debt [sic (=payment protection)] insurance - is problematic and not allowed everywhere … Historically the risk involved in lending, periculum sorties, was one of the first reasons to allow a reward for lending, to circumvent a ban on interest.”

- „In some cases the total set of charges may be limited by regulations on usury“.


In its Report on the operation of Directive 90/88/EEC from 12 April 1996 the Commission concluded as far as cost elements were concerned, as follows:

..[the meeting on this subject organised in April 1995] and the results from Professor Seckelmann’s study have indicated that the Member States use almost the same elements in their calculations and that existing differences were minimal.

The report notes that the number of elements which could be considered as cost elements is theoretically infinite. It notes also that the regulations in force in Denmark, Greece, Ireland, Italy, Luxembourg, Portugal and in Norway are close to the form of article 1a of the Directive whereas Spain, France, Finland, Sweden and the UK do not make any express mention of Article 1a. And it concluded that the UK excludes mandatory life insurance from the calculation.

**para 110: According to the particular country, these differences in interpretation of article 1a, 2(v) may result in differences in the calculation of the APR for identical products. In contrast with the costs excluded by sections (i)-(iv) of this article, insurance premiums represent a significant cost element for the consumer (they can make up a quarter of the credit cost in some cases)**

In April 1996 the Commission proposed a Directive on a single mathematical formula for the calculation of the APR in the various Member States.\(^8\) On April 10 1996 the Consumer Council reached a common position on this proposal, the position paper including a recital to call for a study to report on further opportunities for harmonisation of the inclusion of cost elements.

The development of approach is described by the „Job Description“ for this study:

> "Whereas it is appropriate to study without delay to what extent a further degree of harmonisation of the cost elements of consumer credit is necessary in order to put the European consumer in a position to make a better comparison between the actual percentage rates of charges offered by institutions in the various Member States, thereby ensuring harmonious functioning of the internal market."

2. Summary of Arguments presented in the National Expert Group

The discussion in the expert group was introduced by a previous French document outlining examples which should demonstrate that

> in a number of cases the APR figures obtained according to the French law are systematically higher than those obtained if the legislation of other Member States is applied because the latter, contrary to the French practice, officially exclude certain cost items from the APR calculation. the French authorities hence argue that there is a need to harmonise the APR composing elements by means of the adoption - at an EU level - of a positive list.\(^9\)

France’s concerns set out in Council working document SN/1604/97 are based squarely around cross border comparability of the various APR figures. The French argument is essentially that the use of a negative list does not allow cross-border comparability and consequently she favours an indicative positive list. According to the report of the Commission, the French APR calculation includes more cost elements than is the practice in other Member States. The document highlights the following issues:

1. In the case of a loan granted for financing a car purchase, registration costs demanded by the State as security are included in the calculation of APR in France, but excluded in Austria;
2. Mandatory „death insurance“ is excluded in UK but included in France

\(^8\) see Wimmer, K./Stöckl-Pukall, Neuregelung der Effektivzinsberechnung, in: die Bank 1/98 p. 33 ff

3. Card payment charges are not included in the UK where dual pricing is permitted, merchants normally receive from their card customers a „merchant fee“
4. Payment charges in general such as direct debit, cheque etc. are not included in Denmark
5. Article 1a 2(ii) file related costs charged by sellers to their clients are not corroborated by Commission report
6. Fees for not using a credit facility - inconsistencies in France, never mind across EU
7. Finland excludes mandatory insurance
8. Initial fees are not included in the UK
9. Mandatory German insurance to allow a no-cost payment holiday is excluded
10. Austrian bank statement fees are not included (Cf. Example 4)

The Commission has commented on the French criticisms giving further explanation to their report. According to this explanation, the Commission finds that the exclusion of taxes from the APR is in line with the Directive as far as they are part of any guarantee cost. Dual pricing fees for using a card irrespective of the nature of the card used should not be included. The report further finds no evidence of any such cost enumerated in No 5. In the case of Finland, according to the Report mandatory insurance is included. The Report does not corroborate the submission that in the UK initial fees are not included. In the other examples, the Commission wanted first to verify the situation with the respective country.

At the expert meetings the Belgian delegation have supported the French view. Their contribution is to amend Directive 87/102 EEC by deleting „abnormally high“ due to it’s lack of certainty and to delete „only when they are imposed by the creditor as a condition for credit“ Accordingly, Belgium advocates the inclusion of payment protection insurance premiums into the APR calculation, whether these are compulsory or not. Further they see as desirable the:

- Prohibition of mixed life insurance / credit contract coupling
- Exclusion of VAT from APR (type) calculation
- Card payment related costs to be included where relevant

The Austrian delegation have highlighted the unsatisfactory nature of the exemption for charges for the transfer of funds, as per Belgium because of the lack of certainty surrounding the meaning of „abnormally high“

They also note that, with reference to the exemption for insurance premiums, where these are referred to as voluntary in the contract but that in fact this insurance must be taken to get the credit, this should always appear in the APR.

Finland favours a positive list to allow comparisons between Member States. The Consumer Ombudsman has no criticisms of the current negative list. The Finnish Bankers Association argues against a positive list.
Germany sees no need for further harmonisation but, if this would occur, favours redrafting of Article 1 (2) to include all costs directly connected with credit in the APR calculation, while rejecting a positive list - „Overburdening the APR with cost elements does not necessarily mean more transparency for the consumer….. we do not see how matters can be improved by including additional cost elements over and above the total cost of credit to the consumer“.

The Monetary Institute of Luxembourg considers that „the Community legislation in force concerning consumer credit is sufficiently adequate to ensure effective protection of the consumer in this matter“ and oppose any modifications, including any drafting of a positive list.

The Swedish consumer agency argues „problems related to the calculation of the APR should be solved without a positive list of these cost elements. It is almost impossible to establish such a list that includes all the costs that might occur."

The UK opposes any further harmonisation leading to higher costs for business. „We consider consumers are now in a position to use the APR as a means of comparing products across Member States and that any further harmonisation of the cost elements would have little, if any greater benefit to the consumer and merely result in additional compliance costs for businesses“.

Most other delegations have not expressly taken a position in the question whether there should be a clarification in the form of a positive list or not and have simply outlined the situation in their country.

C. The Tools of Analysis: Mathematical, Legal and Economic Approaches

1. Mathematical and legal Interpretation

a) Mathematics provides a Tool to Achieve Legally Defined Goals

The calculation of the APR is certainly a task for mathematics. The underlying Job Description for this report required „the assistance of an expert in theoretical financial mathematics“ - also for the analysis of questions of a more normative, legal character such as the inclusion of cost elements in the APR.

Accordingly, the author of this study has worked together with an expert in theoretical financial mathematics whose day-to-day work in a major bank consists

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10 13 Oct 1997 letter from Solms-Sieglin to Thierry Vissol DG24
12 Letter from V Nordenanckar to Thierry Vissol 15 Oct 1997
13 Letter from T Single, DTI to Thierry Vissol 16 Oct 1997
of developing computerised methods of calculation for financial services. However, both experts agree with the statement already cited by Professor Seckelmann in his report, a statement actually made in 1988:

"The principal difficulty is not in the field of mathematics. The real difficulty is to determine which items of charge are to be included in making the calculation. The approach leads to the distinction between items for which the borrower has to pay but for which he obtains something in return - such as insurance cover, maintenance service and so on - and items in exchange for which he receives nothing."  

This issue has to be underlined for the present report. An incorrect identification of questions concerning the disclosure of the APR as being of mathematical concern has important problems for the law: Firstly lawyers and legislators may tend to leave normative decisions to mathematical experts who are neither equipped nor suitable to decide upon them. Secondly, mathematicians may be tempted to undertake this task applying their own normative concepts such as „logic“ or „natural laws“ to social phenomena - for which tasks they are equally neither adequate nor appropriate.

The following statements should provide guidelines where the question of APR disclosure is discussed:

- Mathematics provides a methodology to combine purely quantitative phenomena, especially those defined by units of money and time such as in financial services if the law provides
  - which elements can be combined
  - which units have to be applied (year, month, days, percentage, currency)
  - and how the various relations should be calculated (added, subtracted etc., compounding periods)
- Mathematics can demonstrate the effects of such combinations but cannot help with the question of how they should be combined
- There are a multitude of factors such as political acceptance, social compatibility, economic efficiency and logic that may influence a legal decision concerning which elements should be combined.

In the pre-electronic era financial mathematics played an important role in lowering the costs of the workload banks have to manage, due to the fact that their products require repeated calculations (and not because these calculations are difficult to understand.)

In fact, the basic mathematical rule in financial services concerning cost elements of financial products consists of the simple formula

\[ \text{interest} = \text{time} \times \text{capital} \times \text{rate} \]

But historically this simple formula required numerous calculations and a significant workload for financial service providers. It requires that during the time period for

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14 G Hoon Doc C2-71/88 COM (88) 201 final PE 127.173
which interest is calculated (or the rate is calculated if the interest is known) „capital“ and „rate“ have to be constant. These periods can be quite short when payments are made and cost or interest are compounded. Banks even had to close their branches for the public during „bank holidays“ to be able to do these calculations.

Financial mathematics played an important role in providing formulae to facilitate several calculations in one calculation, itself facilitated by a formula.

One of these formulae marked real progress in so far as the compounding periods for interest no longer led to the need for repeated calculations because the question for the increased capital \([K_1]\) (where the accrued interest can be defined by a simple subtraction form the original capital \([K_0]\)) could be solved by the formula that has now been legally acknowledged by the Directive. In this simple formula \(z\) stands for the interest rate and \(t\) for the time - which is now easy to calculate with the help of a computer or a pocket calculator:

\[
K_1 = K_0 \times (1 + z)^t
\]

Thus, a capital of EURO 1,000.- with an interest rate of 8% over 4 years where the interest is compounded annually needs no longer to be calculated in four steps (first year on the original capital, second year on the original capital + accrued interest etc) but can be calculated in one step so that the true result is \(1000 \times (1+ 0.08)^4 = 1360.49\) which amounts to accrued interest of 360.49 Euro.

But all other formulae or simplifications that have been developed to cope with changing time periods (month = 30 days, year = 360 days) are out-of-date in the computer age. The problems associated with a multitude of calculations are solved by a machine that is able to perform millions of calculations in a second.

There can be no serious argument against a correct and fractional calculation of interest and interest rates that obey the above cited simple formula if a computer is available at the stage where the product is designed. As the Directive has excluded very small amounts of credit as well as non commercial credit from its scope, mathematical arguments cannot be taken forward to favour one or other solution.

With the help of computer spreadsheet software, almost any logical person could apply the above mentioned formula to the calculation of any credit imaginable. The task to be undertaken consists of simple bookkeeping - entering cost elements as well as payments by the creditor at the time they were made with a negative value and repayments at their respective date with a positive value into the fields of the spreadsheet, as demonstrated below. If this is done, the capital defined as bearing interest has to be multiplied by the factor \((1+i)^t\) for that time in which the capital remains the same (not regarding the compounded interest). The result has to be taken as the basis for the next calculation and so on. If the amount of all costs including the net capital is known or if the sum due at the time the contract expires is known, each spreadsheet programme provides for a procedure in which such a value can be inserted and the programme asked to repeat calculations with different interest rates as long until such interest rate is found which brings the capital exactly to the required amount.
There is no other secret in financial mathematics as far as interest calculation is concerned.  

\[ b) \text{ Repayment-Flow Calculations versus Mathematical Formulae} \]

The impression that mathematics are an important argument for one or the other solution is often given by formulae reproduced in most of the books concerned with APR calculations. Lawyers may tend to be wary of a language they do not understand even if the message is quite simple. Mathematicians on the other hand seem to guard their influence within banks and financial institutions by showing little impetus to demystify this language. And academic mathematicians show little or no interest in this field. Accordingly, the following development of such a formula out of simple mathematical procedures is an attempt to demystify financial mathematics for its use by lawyers.

(1) Simple interest formula

\[ K_f = (1+z) * K_0 \]

Where \( z \) is the interest rate and \( K_f \) the capital inclusive of interest after a period - is the starting point for the following examination.

After two periods this results in \( K_2 = (1+z) * K_f = (1+z)^2 * K_0 \). Generalised, for the capital after \( n \) period this produces \( K_n = (1+z)^n * K_0 \)

These calculations lie behind the normal power calculation. Accordingly, it is not necessary that \( n \) is an integer, ie. that it may not contain any decimal places. And if the level of capital following a half-period must be calculated then this may be produced through the following form - and can also be solved with the help of a standard calculator:

\[ K_{1/2} = (1+z)^{1/2} * K_0 \]

This proof is to find out a daily rate of interest.

Example:

\( K_0 = 10,000 \) is paid out on 01 Jan 1997 at an interest rate of 3% per annum. On 30 June 1998 \( K_0 \) should be paid back inclusive of interest.

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\( ^{15} \) There are totally different questions at stake where risks and probabilities have to be calculated

\( ^{16} \) see for example Wimmer/Stöckl-Puckall, Die neue Preisangabenverordnung, Beck: Munich 1997; the new German official administrative explanation of the calculation of the APR starts with formulas but finally also explains how the same can be done by a spreadsheet.

\( ^{17} \) The author is actually guiding a doctorate on APR calculation together with a professor of mathematics who insists that the point of gravitude of this dissertation must lie in the legal field because from a mathematical viewpoint the question do not justify a doctorate.

\( ^{18} \) \( n \) is called exponent
Problem: what is the amount to be repaid?

Solution: 1997 has 365 days as does 1998. 30 Jun 1998 is the 181st day of 1998. Repayment takes place on the 546th day, Thus for the comparison one is left with the exponent \( n = \frac{546}{365} \).

\[ K_r = 1.03^{\frac{546}{365}} \times 10,000 = 10.452. \]

The procedure works independently of whether the contributions to be subject to interest are positive (payments in) or negative (payments out)

(2) Composites for contributions liable to interest

Credit payment schedules represent payments which are to bear interest and which are dependent on each other. As a rule, this schedule begins with the payment out of the credit amount. Repayments (interest and capital) follow periodically from this point. The goal of these payments is the repayment of the amount of credit (ie. the advance) at the end of the term.

(3) Presentation as payment-flow

A payment-flow or cash-flow presentation is a table produced from the interrelationship of time and payments (with algebra)

Example:

\( K_0 = 10,000 \) Credit advances
\( z = 3\% \) interest is due at the end of the year

Two lots of 5,000 will be repaid at the end of the year, thus a two year term

Payment schedule:

<table>
<thead>
<tr>
<th>Date</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>01 Jan 97</td>
<td>-10,000</td>
</tr>
<tr>
<td>31 Dec 97</td>
<td>5,300</td>
</tr>
<tr>
<td>31 Dec 98</td>
<td>5,150</td>
</tr>
</tbody>
</table>

(3) Presentation as a formula

The repayment flow from the example may also be presented as integrated into a formula:

\[ 0 = -10,000 \times 1.03^2 + 5,300 \times 1.03 + 5,150 \]

Generalised this may be presented as:
Harmonisation of Cost Elements of the Annual Percentage Rate of Charge (APR)

Formula 1a)

\[ 0 = \sum_{k=1}^{m} (A_k \times (1 + z)^{tk}) \]

\( k \): variable for counting  
\( m \): number of payments  
\( A_k \): Payment  
\( z \): APR  
\( t_k \): Time between payment of the principal and repayment \( A_k \)

The following presentation represents conversion from the time of the paying out for the credit until the payment time\(^{19}\)

\[ 0 = \sum_{k=1}^{m} \left( \frac{A_k}{(1 + i)^{tk}} \right) \]

\( k \): variable for counting  
\( m \): number of payments  
\( A_k \): Payment  
\( i \): APR  
\( t_k \): Time between payment of the principal and repayment \( A_k \)

This formula corresponds with the formula for the Annual Percentage Rate according to Directive 87/102/EEC.

On examination, it also becomes apparent that the time \( t_k \) and the connected payments \( A_k \) are dependent on the credit payment flow. For particular special variations the payment flow may be integrated into a formula presentation without further modification, but for general calculations this obscures matters. For every payment flow and for all compiled payment flows, Formula 1) allows the determination of an Annual Percentage Rate.

(5) Development of an integrated formula

Example of a complete integrated presentation:

For the relatively simple, particular case of an annuity loan with monthly instalments and without additional payments, such as continuing costs (one-off costs are simply subtracted from the amount paid out) there is the following formula\(^{20}\):

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\(^{19}\) in financial mathematics terms, this concerns the equivalent cash-value examination

\(^{20}\) the formula for the residual debt in the case of annuity? loans is presented, for example in Wagner, E (in German) Effektivzins von Krediten und Wertpapieren, Helmut Richardi Verlag Frankfurt am Main 1988
This provides altogether:

\[
1 = \sum_{k=1}^{J \times 12 + g \atop \text{variable for counting}} \frac{1 + \frac{z}{1200} \left( J \times 12 + g \right) - 1}{1200 \times (1 + \frac{z}{12})^g}
\]

\(k:=\) variable for counting
\(J:=\) life time in full years
\(g:=\) life time number of residual periods
\(m:=\) number of payments
\(z:=\) nominal interest rate
\(i:=\) APR

The solution towards \(i\) provides the Annual Percentage Rate

For this particular case, some further elements may expand the formula without further modification to bring in, for example, payment holidays, continuing charges et cetera. Similar approaches must be developed for other repayment variations such as classic installment credit, repayment loans and every other type. However these cannot be calculated added together with, for example, savings payments. The formulae are only useful for the special cases for which they were developed. And the apparently simple solution to \(i\) must also be calculated with a computer. A conversion in the formula for \(i\) is not generally possible.\(^21\) With the help of modern calculators and standard computer software – spreadsheets - a value for \(i\) may always be calculated. A normal calculator is always suitable to duplicate results.

Flexibility is the essential advantage of the implementation of the Annual Percentage Rate on the basis of payment flow. A simple spreadsheet calculation is sufficient to present the payment flow and to work through the analysis according to Formula 1b). Here one has neither pages and pages of formula nor is one tied to a restriction of repayment or savings variations. Next to that, a payment flow calculation certainly shows the effect of the mathematical addition sign \(\Sigma\), whose shorthand form would conceal the actual payment flow to the casual reader at first sight.

(6) Result

The working out of tables of payments, such as for example, payments of credit and repayments can most easily be completed using spreadsheet software directly with payment flow. Providers of special products in the mass market benefit most from using formulae in the credit offer material. And in the proofs of these offers it is important to look for simplifications and limitations of application which are not always obvious. A calculation using payment flow is always comprehensible.

\(^{21}\) a formula such as \(i = ABCD\ldots\) is meant
c) The Calculation of Cost Elements in Spreadsheet (Repayment-Flow) Calculations of the APR

(1) The Basic Form

In the following tables an ordinary instalment credit is calculated according to the repayment flow method with a spreadsheet program.\(^{22}\)

The easiest and also the most appropriate way of calculation would be to require just three items of data for ordinary consumer credit: the amount the consumer receives (principal) and the amount he must pay (i.e. time and amount of the instalments) as well as the life time of the credit agreement.

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**Table 3: Input Date of the Credit**

<table>
<thead>
<tr>
<th>Input Data</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Net Credit</td>
<td>10.000,00</td>
</tr>
<tr>
<td>Date of Payment of the Principal</td>
<td>1.1.1998</td>
</tr>
<tr>
<td>Life time of the credit in years</td>
<td>1</td>
</tr>
<tr>
<td>Number of Instalments per year</td>
<td>2</td>
</tr>
<tr>
<td>Instalment(^{23})</td>
<td>5.376,97</td>
</tr>
</tbody>
</table>

This data is now introduced into the spreadsheet filling the first two columns. Mathematically the principal received by the borrower has to have a negative value if his or her payments are introduced as positive values into the payment flow column.

**Table 4: Basic Spreadsheet to calculate the APR**

<table>
<thead>
<tr>
<th>Date</th>
<th>Payments</th>
</tr>
</thead>
<tbody>
<tr>
<td>01.01.1998</td>
<td>-10.000,00</td>
</tr>
<tr>
<td>30.06.1998</td>
<td>5.376,97</td>
</tr>
<tr>
<td>31.12.1998</td>
<td>5.376,97</td>
</tr>
</tbody>
</table>

\(^{22}\) Standard software are Excel, Lotus, Quattro Pro and others. Such programmes are available at prices below 30 ECU as freeware.

\(^{23}\) Annuity is composed of interest and amortisation
All other values can be derived from these inputs by simple application of the EU-formula.

The spreadsheet then looks as follows:

Table 5: Basic Spreadsheet (A1 ..F6) to calculate the APR

<table>
<thead>
<tr>
<th>Date (A1)</th>
<th>Payments</th>
<th>Interest</th>
<th>Amortisation</th>
<th>Amount</th>
<th>Years</th>
</tr>
</thead>
<tbody>
<tr>
<td>01.01.1998</td>
<td>-10.000,00</td>
<td>0,00</td>
<td>0,00</td>
<td>- 10.000,00</td>
<td>0,00</td>
</tr>
<tr>
<td>30.06.1998</td>
<td>5.376,97</td>
<td>- 495,89</td>
<td>4.881,08</td>
<td>- 5.118,92</td>
<td>0,49</td>
</tr>
<tr>
<td>31.12.1998</td>
<td>5.376,97</td>
<td>- 258,05</td>
<td>5.118,92</td>
<td>0,00</td>
<td>1,00</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td></td>
<td></td>
<td></td>
<td><strong>10.000,00</strong></td>
<td></td>
</tr>
<tr>
<td><strong>APR</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>(F6)</td>
</tr>
</tbody>
</table>

The APR \((i)\) is now the interest rate which increases the amount of - 10.000 ECU in each time period \((t)\) by \((1+i)^t\) to such an amount that the final amount is 0 ECU.

For this procedure all spreadsheets provide a special function of approximation which requires only three additional entries:

Table 6: Approximation Procedure in Spreadsheet Calculation

<table>
<thead>
<tr>
<th>Which Data shall contain the Final Value?</th>
<th>E4</th>
</tr>
</thead>
<tbody>
<tr>
<td>Final Value?</td>
<td>0</td>
</tr>
<tr>
<td>Which Data shall be Variable?</td>
<td>B6</td>
</tr>
</tbody>
</table>

It will then adjust the variable containing the APR to the true value. In the example above this would be **10,291% p.a.**

(2) Confusion with Internal Interest Calculations

This simple approach is often confused with the problem that credit providers calculate their „interest“ in relation to the outstanding capital with quite sophisticated formulae where arbitrary assumptions are made about time and values. This „internal calculation“ has nothing to do with the APR calculation. It is only a means of creditors to fix the amount a borrower has to pay back. It is up to the credit provider to provide and define the method how he wants to calculate the „interest“.

The APR can only be calculated if the amount of repayment at the date when it falls due is clear. APR calculation of hypothetical offers of credit have accordingly always to be done in two totally independent steps:

- Calculation of the payment flow; and
• Calculation of the APR based on the payments’ flow.

(3) How to Introduce Additional Cost Elements into the APR Calculation

In principle there is no difference if additional cost elements have to be included. All cost elements are simple payments and must be introduced into the repayment flow at the time when they fall due.

Cost elements have either to be paid by the borrower at a certain time - which makes them part of ordinary repayments - like fees for bank accounts or some types of insurance premiums. If they have to be paid up-front they are deducted from the principal, which leads to a lower payment by the creditor.

In the example of an up-front fee, if this fee were twice the amount of 76.97 ECU equalling 153.94 ECU but debited in such a way that it were equally distributed to all instalments (as is usually the case), then the above chart would not be changed at all. Nominally the instalment would be 1,300 ECU for interest plus 76.97 ECU for an initial fee which, mathematically, is in fact a running fee. For example, analogous to fees for the administration of a bank account which are debited to the account on a regular basis. Nothing would change for the APR calculation. Only the way in which the credit provider would calculate the cost internally would be different (less interest, more fees).

If on the other hand the credit provider were to charge such a fee as a true up-front fee - as with brokers’ fees or insurance premiums in most countries - then the consumer would either have to advance this amount as an additional payment or it would be deducted from the payment of the principal the credit provider makes to the borrower.

Both ways do not make any difference to the form of calculation. But as these payments have to be made earlier than in our previous example, we have to take the present value of the two payments of 76.97 ECU at the time when the amount is debited from the payment flow account. As this present value at the given APR is 143.33 ECU it has the same effect on the APR as in our previous case. Only now the account stands not at -10.000 ECU at the beginning but rather at -9.856,87 ECU. The instalments are reduced to 5,300 ECU.

Table 7: Input Date of the Credit with up-Front Fee

<table>
<thead>
<tr>
<th>Input Data</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Net Credit</td>
<td>10.000,00</td>
</tr>
<tr>
<td>Initial Fee</td>
<td>143,13</td>
</tr>
<tr>
<td>Date of Payment of the Principal</td>
<td>1.1.1998</td>
</tr>
<tr>
<td>Life time of the credit in years</td>
<td>1</td>
</tr>
</tbody>
</table>
(4) **Which Cost Elements are to be Introduced**

The decision as to which elements of the payment made by the borrower can be treated as cost elements for services which must be kept distinct from the APR calculation is a purely legal question.

If it is legally decided that such costs are not part of the „credit cost“ then mathematically such costs would have to be omitted from the calculation and consequently from the payment flow. This is clearly the case when, for example, a borrower takes a taxi to the bank. It is of course the “hard cases” which are problematic - nobody would think of introducing the price for the transport into the APR of the credit taken with this bank.

The problem essentially arises where creditors themselves mix such cost elements with the credit in such a way that they become difficult to separate for the purpose of the APR calculation.

All cost elements including those that are not represented in the APR are part of the payment flow between customers and banks. While many of them are added to the credit amount and thus financed together with the credit, the credit providers do not properly disclose a pure payment flow for those elements which they do not want incorporated into the APR.

This contradictory behaviour leads to important problems for the consumer. The given APR can only be verified if the respective payment flow is disclosed or in other words if such „additional services“ are kept apart from the credit agreement and are also paid for separately.
Taking the example of the above mentioned up-front fee. If a creditor charges such a fee he can distribute it to the instalments making it an element of the payment flow which is invisible and difficult to trace. If he deducts it from the capital advance it becomes part of his own payment flow and if he charges it outside the credit agreement it is even more difficult to trace.

It should not be the task of the legislator to define how interrelated financial products can be separated for the purpose of APR disclosure. If the creditor himself is not able to provide a pure „credit payment flow“ table where such elements are omitted this, as we will see later, gives a strong indication that the products are indeed so inseparably linked to each other that also their cost elements cannot be distinguished sufficiently. An inclusive approach to such elements would certainly come close to the general principle of disclosure rules in consumer protection that „What You See is What You Get“ or in other words that the provider is responsible for appropriate product disclosure where the necessary calculations are understood by consumers.

2. Legal and Economic View

While the role of mathematics seems to be largely overestimated in the importance for APR-legislation the opposite seems to be true as far as economics are concerned.

The APR legislation serves two goals which are concisely expressed in the motion of the consumer council:

1. In order to put the European consumer in a position to make a better comparison between the actual percentage rates of charges offered by institutions in the various Member States,

2. thereby ensuring harmonious functioning of the internal market

In defining the aims of this study it not only repeats the core elements of the general deliberations which have accompanied the introduction of the Directive but also refers to two important legal goals of the European treaty itself:

- consumer protection (Art. 3 a liniea 1 letter t Treaty)
- realisation of a common market (Art. 3 a liniea 1 letter c Treaty)

Both goals are primarily economic goals. The introduction of the APR has therefore to be evaluated in the light of economic achievements. In other words, the test of efficiency of such legislation can only be conducted with tools of economic and empirical analysis.

This is clearly expressed in the Directive itself. Its language uses predominantly economic terms which are not legally defined and therefore revert to economic analysis especially as far as the core notion of the directive „cost“ (total cost, charges) is concerned. It equally governs the definition of how these costs are attributed to a credit (cost of the credit). As we will see later, this principle is partly obscured in that part of the Directive, where exceptions are no longer defined in an economic but rather in legal wording using the notion „obligatory“ which certainly derives from „legal obligations“.
But this does not change the overall quality consumer protection law enjoys in the legislation of the European Union. Article 14 of the Directive provides a general purpose anti-avoidance provision which unquestionably forces the Member States to submit their transposition of the Directive to an economic test:

**Article 14**

1. Member States shall ensure that credit agreements shall not derogate, to the detriment of the consumer, from the provisions of national law implementing or corresponding to this Directive.

2. Member States shall further ensure that the provisions which they adopt in the implementation of this Directive are not circumvented as a result of the way in which agreements are formulated, in particular by the device of distributing the amount of credit over several agreements.

It states a legal obligation to pursue an economic goal: the protection of the consumer. Alinea 1 makes consumer protection an explicit legal goal referring to the ***detriment of the consumer*** as a notion that is not defined by law but by economics. In alinea 2 law and especially contracts are even addressed as a means to ***circumvent*** the (economic) purpose of the Directive. Art. 14 can therefore be seen as a guideline that gives the goals of the consumer council a legal foundation. It requires that the effects of any form of regulation in the Directive and especially those prescriptions concerning the APR and its representation of credit cost are evaluated “economically” as to their effects for the consumer.

Two principles for the evaluation derive from these deliberations:

- Transparency and equal presentation of equal credit costs have to be safeguarded
- This has to be done from the viewpoint of a consumer

**II. The Legal Analysis**

**A. The Philosophy of the Directive**

1. **Overview**

The Directive’s approach to harmonise the disclosure requirements for the APR was essentially a compromise between different historical uses of the APR concept. The philosophy of its regulation changed according to the dominant forms of credit as well as with its use. The following table attempts to systematise these developments where the relative depth of shadow indicates importance in a certain decade. Clearly all forms and purposes of consumer credit still exist and, according to the development of financial services and economic development in the different member states as well as even inside the different regions of one member state, historically earlier forms and purposes may prevail.
Harmonisation of Cost Elements of the Annual Percentage Rate of Charge (APR)

Table 9: Philosophies of Consumer Credit Regulation in a Historical Perspective

<table>
<thead>
<tr>
<th>Time</th>
<th>19th Century</th>
<th>1920s</th>
<th>1960s</th>
<th>1980s</th>
<th>1990s</th>
</tr>
</thead>
<tbody>
<tr>
<td>Forms of Credit</td>
<td>Hire Purchase/ Instalment Purchase</td>
<td>linked transactions</td>
<td>free fixed rate instalment credit</td>
<td>variable rate credit card and overdraft</td>
<td>Financial Service packages</td>
</tr>
<tr>
<td>Purpose</td>
<td>Furniture</td>
<td>household equipment</td>
<td>Motor vehicles</td>
<td>cash flow</td>
<td>life cycles</td>
</tr>
<tr>
<td>Philosophy of Regulation</td>
<td>PREVENT EXORBITANT BURDEN (USURY)</td>
<td>RESTRICT CREDIT USE (CASH SOCIETY)</td>
<td>FURTHER COMPETITION (MARKET)</td>
<td>PROTECT CONSUMERS</td>
<td>ANTI-DISCRIMIN.</td>
</tr>
</tbody>
</table>

- Historically, APRs had their special importance within the law only in usury legislation which existed in all countries in the 19th century. Only after the Second World War did the ideas of truth-in-lending and price transparency become more important especially in the UK and Ireland as well as the Scandinavian countries while rate ceilings remain the major concern in APR-discussions in France, Belgium and, to a lesser degree in Germany.

- In addition there have been two options to define the purpose according to the object of comparison: comparing credit to cash purchase or to other credit.

- Another difference can be seen in the distinction between mortgage loans and consumer credit. Most countries treat consumer credit and mortgage loans equally as far as APR disclosure is concerned while a few follow the restrictive approach
of the Directive and apply these provisions only to consumer credit in a narrow sense.\textsuperscript{24}

- Finally the Directive is focused on single credit transactions, largely omitting the modern tendency towards variable credit in a financial services environment.

The decision as to which approach one follows has crucial implications for deciding which cost elements should be included in the APR.

- With a total cost of credit approach the absolute amount of money which is specifically due to the financing itself (and not to the purchase or investment) has to be made clear to a borrower.

- With a usury approach the income of the creditor has to be represented by the APR so that his total profits can be measured while third parties' income can be omitted.

- With a competition approach all those elements have to be included that are specific for the hypothetical standard product „consumer credit" while the price for extra services should be excluded. (see Art. 81 (1) letter e Treaty)

- A consumer protection approach is more difficult to define because it takes up elements of all approaches but from a specific viewpoint. Although in this respect it wears several hats, it must be defined consistently, also as a single approach. This approach we have divided elsewhere\textsuperscript{25} into individual, social and collective consumer protection where individual consumer protection aims at the freedom of decision and choice (price disclosure, transparency), the social protection at the inclusion of social elements of the individual into the legal concern (default, overindebtedness, refinancing, usury) and collective consumer protection the question of discrimination and equal distribution. (see Art. 136 ainline 1, 137 (2) ainline 3 Treaty)

- Anti-Discrimination as a form of collective consumer protection uses some elements of the traditional usury approach. It aims at coping with the effects of individual consumer protection where additional cost burdens as well as restrictions on higher charges to weaker consumers lead to a tendency where suppliers either increase the prices for weak consumers or withdraw their offers from certain consumer groups and regions. (see Art. 3 ainline 2 ; 136 (2) ainline 3 Treaty)

As we will see throughout the analysis, the Directive as well as national legislation does not provide a consistent approach. There are a mixture of different approaches

\textsuperscript{24} In the USA and the UK the term consumer credit comprises mortgage loans which is correct in so far as housing is part of individual consumption.

\textsuperscript{25} see Overindebted of Consumers in Germany - The Example of Consumer Credit - Report for DG XXIV of the European Commission, by the Institute of Financial Services ( Udo Reifner, Susanne Veit, Diana Siebert) Contract No. \ March 1998 Chapter I B 1.
protecting consumers without defining expressly what this means. The present study can hopefully add to this endeavour which has a much broader significance for the emerging European law than is apparent in this specific question of APR disclosure.

2. Truth-In-Lending, Usury and Anti-Discrimination

In order to take the trouble to consider purchasing consumer credit products from a different EU Member State, consumers need to have confidence not only that they will not be unwittingly penalised, but also that they will benefit. This question of trust is doubtless central to the effectiveness of the Directive and the APR calculation.

The principle behind the Directive was based around the concept of truth in lending - providing the consumer with a total cost for credit in a useful form, encompassing all of the costs arising, rather than just the basic interest rate. This should allow the consumer easily to understand and be in a position to consider the overall cost of borrowing money (i) in general terms (ii) relative to different durations of term of the credit agreement and (iii) relative to other consumer credit offers made in the home State and throughout the EU/EEA.

Whereas the recitals in the Directive clearly refer to single market aims and not, for example, consumer protection specifically against usury, even the Commission’s own report26 refers to measures to combat usury. APRs have of course been used in many Member States to identify usury prior to the Directive.

The Directive also makes a concession to such practice when it states:

3. (a) Where credit transactions referred to in this Directive are subject to the provisions of national laws in force on 1 March 1990 which impose maximum limits on the annual percentage rate of charge for such transactions and, where such provisions permit standard costs other than those described in paragraph 2 (i) to (v) not to be included in those maximum limits, Member States may, solely in respect of such transactions, not include the aforementioned costs when calculating the annual percentage rate of charge, as stipulated in this Directive, provided that there is a requirement, in the cases mentioned in Article 3 and in the credit agreement, that the consumer be informed of the amount and inclusion thereof in the payments to be made.

Although apparently none of the Member States has made use of such exemptions the underlying philosophy that APR-legislation for usury may require different definitions of the cost elements than truth-in-lending has quite important repercussions.

In France, the Netherlands, Belgium and in future also Italy the APR calculation is used as a measure against usury under usury legislation - setting a maximum APR based on average APRs. In Germany the civil courts have developed a usury case-law based on the rule that double of the average is enough. For this purpose they

26 op cit pp 9, 64, 78
had to define the APR of credit contracts which largely influenced the price disclosure law and vice versa. Both APRs can now be assumed as being identically calculated.

Usury regulation, in the traditional sense of fixed rate ceilings as used especially in some States of the USA are now somewhat out of date. The assumption that high interest rates are always to the detriment of consumers is wrong. Productive use of consumer credit is also possible in high interest periods. The benefit from using credit will mostly still be higher than its cost. But there is a new context for usury legislation which is especially visible in the German form of usury ceilings but also in the more sophisticated way usury ceilings are today fixed in the Latin countries.

Usury rates are no longer evaluated as such but in relation to markets. Usury was defined in 1981 by the German supreme court as a misuse of market power to the detriment of consumers. Consumers who take out credit whose APR together with its burden in default situations is significantly above the average market rate and the typical charges in default is assumed to be in conflict with the principle of good morals.27 When instalment banks claimed that they were especially serving low income consumers and asked for a „special market“ approach in which a higher average was calculated for high risk consumers the Supreme Court rejected this approach forcing the banks partly to cross-subsidise perceived costs in the lower market segments.

Modern usury legislation has the opportunity to cope with the problem that „the poor pay more“ or, in other words that high risk consumers are burdened with the cost of their risk groups thus making them carry the social burden of society irrespective of whether they personally will default or whether their high risk can be referred to them. In a form of self-fulfilling prophecy modern market policies which „cherry pick“ to the detriment of low-income consumers tend to charge the latter so much in additional fees that they default - not necessarily because they are high risk but also because they carry a high cost burden.

If one can learn from the mistakes made in the US consumer credit market such developments inevitably lead to impoverishment and an increasing polarisation between rich and poor which burdens society with all kinds of regional, sexual, age and racial discrimination through asocial market mechanisms. Accordingly the main concern with consumer credit in the USA is its equal accessibility for all applicants. The Equal Credit Opportunity Act as well as the Home Mortgage Disclosure Act and the Community Reinvestment Act all provide tools to encourage banks into providing credit for all areas and income groups. But such pressure cannot successfully be exercised without regard to cost elements.

If credit cost can be so high that equal access to credit is guaranteed but the whole burden of this approach is carried by the poorer segments of society then access is certainly denied. But on the other hand, usury ceilings have the perverse effect that discrimination of poorer clients and regions may increase. In any event, usury

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27 see for more details Reifner/Veith, Overindebtedness and Consumer Credit - Expertise for DG XXIV March 1998
ceilings, which are not homogeneous in the EU, discriminate against banks from paternalistic states like Germany, France, Belgium and the Netherlands in their opportunity of transborder credit for such market segments.

Neither national states nor the EU can prescribe risky credit extension without accepting the responsibility for credit failure. Equally, the allocation mechanisms of offer and demand have to remain basically untouched. Accordingly, market mechanisms have to be mobilised which improve competition but also corporate social responsibility.

Such effects have been studied where wealthier consumers and especially institutional investors such as pension funds, churches, local authorities and trade unions have used information about discriminative behaviour of banks as a criteria for their banking behaviour, thus exercising market power for weaker consumers. In this approach the disclosure of the APR is an important tool for raising public consciousness about the allocation of social risks to the weakest consumers in the market being dangerous for the cohesion of society and the future of equal economic opportunity.

The mention of overindebtedness and usury in the Directive as well as the use of the APR to identify usury in five Member States can be seen as an indication that a specific European approach to APR disclosure includes such goals as the disclosure of those cost elements - which only burden groups which carry the highest risks and have the lowest income and opportunities. Without adequate disclosure rules which expressly accept this additional goal, the combating of social discrimination through market forces in Europe will be impossible.

3. Cash Society Approach or Credit Market?

The Directive has two different definitions of credit cost.

In Art. 1 (2)(e) the APR is defined as follows:

"Annual percentage rate of charge" means the total cost of the credit to the consumer, expressed as an annual percentage of the amount of the credit granted and calculated in accordance with Article 1a."

In Art. 1A introduced through Directive 90/88/EEC of 22 February 1990 the APR is defined as follows:

"1. (a) The annual percentage rate of charge, which shall be that equivalent, on an annual basis, to the present value of all commitments (loans, repayments and charges), future or existing, agreed by the creditor and the borrower, shall be calculated in accordance with the mathematical formula set out in Annex II.

28 see Reifner/Evers, Community Reinvestment in Europe - opportunities for the Development of Social Economy Banking® Contract 96/171 presented by Institut Für Finanzdienstleistungen e.V. (IFF), Hamburg to the European Commission DG XXIII Enterprise Policy, Distributive Trades, Tourism and Co-operatives
In Annex II the APR is defined as

„the basic equation expressing the equivalence of loans on the one hand, and repayments and charges on the other“

The Member States accordingly have a choice between these two forms of definition. While the first form is taken up by countries like Germany and France, where, for example Art. 4 al. 4 of the German Consumer Credit Act contains the following definition,

(2) APR means the indicated total cost of the credit to the consumer expressed as a percentage rate of the amount of the credit granted. The calculation of the effective and initial APR is in accordance with § 4 of the Decree on regulation of price information.

The second form is taken up by the Irish and English legislator where for example the Irish Consumer Credit Act states:

In this Act the APR shall be the equivalent, on an annual basis, of the present value of all commitments (loans, repayments and charges), future or existing, agreed by the creditor and the consumer, calculated to the nearest rounded decimal place in accordance with the method of calculation specified in the Fourth Schedule.

The first definition and, as we will see later also all other more detailed descriptions about the basis on which the APR shall be calculated, is focused on the „cost“ of the credit while the second definition refers to the total repayments which refer to the increased capital. On the background of the mathematical understanding developed above this means that the repayment-flow is the focus of the second definition.

Having understood the impact of the shift from traditional calculation of „interest“ towards the calculation of „increase in capital“ it is obvious that the first definition does not suit a modern understanding of interest as a measurement of capital growth. It assumes that the principal remains unchanged while, separately from the principal, interest arises together with other cost elements while the second definition assumes capital is advanced in order to get back a higher level of capital. Interest is then only the difference - the APR is then a growth rate.

This could be a simple theoretical difference which defines the same phenomenon in a different way. However, the underlying philosophy leads to different conclusions.

In the first definition the cash-society approach is predominant. Knowing the „total cost“ of credit means to know the exact difference between cash price and credit-financed purchase. But this approach is certainly erroneous because 100 ECU interest does not express the real difference between a credit purchase for 1100 ECU and a cash purchase for 1000 ECU. Only if time is introduced does such comparison make sense. A payment of 1100 ECU as the counter-value of being able to spend 1.000 ECU ten years earlier than without credit would show that I had no cost at all
but made a real profit comparing the future value of my purchase\textsuperscript{29} with the future value of the credit.

Accordingly, the cash-society approach is outdated, theoretically wrong and misleading. Consumers and investors compare credit with credit. The question is rather at what rate a credited amount will grow during a certain time period in order to compare it with the “growth rate” of the items purchased with such a credit. As the time period of a credit may be shortened without making any difference to its definition, as a credit, a cash purchase can be easily addressed as a zero time credit.

If the Directive were clearer in this sense, adhering to the more advanced Anglo-Saxon form of definition where “cost elements“ are not seen as a form of „interest“ but as cost items for repayment at the expense of the consumer, then a correct interpretation of the Directive would be easier to arrive at.

\textbf{4. Instalment Credit or Financial Services?}

The second problem concerns the Directive’s focus on simple credit agreements deriving from the historical form of instalment credit, especially occurring as a linked credit agreement. In the interim the market has shifted away from simple credit - where the credit provider derives his income from the interest span - towards financial services where profit stems mainly from fees and service charges. Credit card credit linking payment devices with credit facilities as well as combinations of credit and insurance products are becoming more important, at least in so far as the simple application of the Directive is concerned. In some credit contracts the cost of insurance for all kind of risks like unemployment, death and disablement has already reached the cost of the credit itself. Credit has become a dependant minor part in a variety of other financial services - for example in speculative investments, in fully financed retirement savings plans, in tax-efficient property investment and in using the services of telephone companies who offer credit accounts.

This combination of other financial services only reveals the true nature of credit itself. Credit is a service. It consists of a variety of services which a financial institution puts together to facilitate the credit extension and the pursuit of the credit contract.

All these services together, aside from a profit margin of less than 1% make up the interest span which is visible in the difference between a 2% p.a. savings account and a 10% p.a. consumer credit agreement. What a creditor may do is choose to outsource these services. In that case the services are not originated externally but only made visible through outsourcing. The following table illustrates the different services included in a normal credit contract and the form of outsourcing to third parties. The table attempts to evaluate the cost of such services as part of the effective interest rate where the cost for risks (1.5\%) and for servicing (1\%) are quite stable assumptions while all others are model assumptions only. The table shows that outsourcing in credit normally renders credit more expensive.

\textsuperscript{29} a motor vehicle’ s future value for a consumer is the sum of all potential additional gains of having this car in advance compared with for example using public transportation.
Harmonisation of Cost Elements of the Annual Percentage Rate of Charge (APR)

This is why banks do not outsource such services for all credit contracts, rather, if possible only for those who present costs in terms of risk, administration and acquisition which are significantly higher than the average. By using third parties for these special customers the banks create a situation which Caplovitz discovered in his seminal research in 1963 entitled „The Poor Pay More“.

Table 10: Credit Services and Outsourcing with estimated Value

<table>
<thead>
<tr>
<th>Service as part of a bank credit</th>
<th>Value</th>
<th>Form of Outsourcing</th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Refinancing</td>
<td>2,5%</td>
<td></td>
<td>2,5%</td>
</tr>
<tr>
<td>Acquisition of Savings</td>
<td>2%</td>
<td>Mark-up with refinancing with other banks</td>
<td>1,5%</td>
</tr>
<tr>
<td>Marketing of the credit and Acquisition</td>
<td>1%</td>
<td>Credit Broker, Retailer, Credit Card Company</td>
<td>2%</td>
</tr>
<tr>
<td>Advice, Reception of the customer</td>
<td>0,5%</td>
<td>Credit Broker, Retailer, Credit Card company</td>
<td>2%</td>
</tr>
<tr>
<td>Risk of Failure</td>
<td>1%</td>
<td>Insurance Companies</td>
<td>3%</td>
</tr>
<tr>
<td>Administration of Default</td>
<td>1%</td>
<td>Law-firms/ Insurance</td>
<td>5%</td>
</tr>
<tr>
<td>Servicing of the credit</td>
<td>1%</td>
<td>Assignment to another bank</td>
<td>1%</td>
</tr>
<tr>
<td>Profit</td>
<td>1%</td>
<td></td>
<td>1%</td>
</tr>
<tr>
<td>APR of the Credit</td>
<td>10%</td>
<td>APR of the Credit</td>
<td>18%</td>
</tr>
</tbody>
</table>

The Directive seems to follow a different approach when, in its list of exemptions from the inclusion of cost elements it draws a difference between „cost of the credit“ and „other cost elements“. A financial services approach should make the distinction between credit services and other services without regarding whether these services are performed by the creditor or a third party.

The French regulation follows this approach when it refers to „direct or indirect charges“ by the credit provider or „intermediaries of any sort“:

Selon l’article L.313.1 du Code de la consommation: „sont ajoutés aux intérêts les frais, commissions ou rémunérations de toute nature, directs ou indirects, y compris ceux qui sont payés ou dus à des intermédiaires de quelque manière que ce soit dans l’octroi du prêt, même si ces frais, commissions ou rémunérations correspondent à des débours réels“.

Similarly, the official commentary of the UK Office of Fair Trading to the Consumer Credit (Total Charge for Credit) Regulations 1980 Part II - Total Charge for Credit (858) reads:
Such a charge need not be related to the credit, directly or indirectly: nor need it be payable to the creditor or of any direct benefit to him.

5. Mortgage Loan or Consumer Credit

Finally, it has to be kept in mind that most countries do not distinguish between mortgage loans and consumer credit as far as APR disclosure is concerned. The approach of the Directive does not exclude the application of equal rules to mortgage loans extended to consumers but it does not order this by itself - with one exception: mortgage (secured) loans that do not serve for acquiring land or for an existing or projected building but for other purposes. These are covered by the Directive and the second mortgage market is accordingly under the scope of the regulation.

The tacit application to mortgage credit in most member states is visible in the listing of cost elements. Such listing, which positively defines a special service which is not seen as a „credit service“ makes an abstraction from the form of credit for which this statement should hold. For example, notary fees are exempted in the German regulations\textsuperscript{30} but this has been done with respect to mortgage loans where notary services are indispensable for a credit contract and have to be outsourced by law. In consumer credit the use of notaries is the absolute exemption. But some credit providers have profited from the general exemption by making consumers sign special acceptance of the debt with a notary which, in case of default, facilitates easier court assisted debt-collection.

The Directive in fact covers consumer credit and mortgage loans in most Member States and, to a certain extent, all Member States as far as second mortgages are concerned. Accordingly, any list would have either to distinguish between mortgages and consumer credit or preferably refrain from regulating such services which are specific for one product and not used regularly with the other product.

It follows that negative or positive lists can only serve the purposes of the Directive if they give examples for more abstractly defined elements, or, if lists are produced for each specific credit product as in Regulation Z of the US-American Truth In Lending Regulation\textsuperscript{31} where disclosure rules are specific to different products, although they all refer to a general listing in § 226.4.

6. Summary

- The APR of consumer credit agreements has to be disclosed in order to guarantee transparency for products whose costs are incomparable in a raw form because they are defined by three independent variables - credit amount, cost and time. The calculation has to be construed in a way which allows consumers to compare prices of competing products and services, products and services which serve the same purpose and are interchangeable.

\textsuperscript{30} see Änderung der Verwaltungsvorschrift des Wirtschaftsministeriums zum Vollzug der Preisangabenverordnung (PAngV-Anordnung) vom 18. Dezember 1992 - Anlage 1 Az. : I 4441.31-071/ 16-

\textsuperscript{31} Truth in Lending Regulations (Regulation Z)
• Other purposes such as the prevention of usury are separate but also an inherent goal of price policies. Existing rate ceilings in Europe are defined with respect to a market rate and accordingly presuppose the comparability of products and their cost elements, as is the case in price disclosure law. Efficient usury law is not a reason to deviate from but rather to follow the philosophy of truth-in-lending.

• Prices of credit products can only be compared to the prices of other credit products. This does not exclude the comparison to so-called „cash“ purchases - because logically they can be made comparable by defining them as zero interest credit. Therefore it is not the „interest“ which is the core element to differentiate between transactions but the time as well in relation to the capital received (whether in cash or in the form of a purchased good or service). Mathematically speaking the core element of credit pricing is the payment flow approach which puts all payments from either side into their temporal relationship.

• Consumer credit is an integrated part of financial services. Its cost elements have therefore to be understood as the payment of services integrated into one product. The denomination of the credit price as an „interest rate“ implies that the price is exclusively linked to the use of capital during a specific time period, excluding other fees from any concern. Interest in this traditional form is only a minor part of modern financial services. The annual percentage rate does not describe the reason why cost elements are represented in the rate but only the form which they should be made comparable in respect to similar products. Accordingly it mainly consists of a bundle of different fees for services concerning advice, presence, administration, risk taking and refinancing.

• It does not change the basic structure of the price of credit services if part of such services are outsourced to third parties.

• The philosophy of the Directive requires a definition of which products can be assumed to be comparable. This definition depends largely on the factual situation in the market and the development of new financial products. Lists of included or excluded cost elements are dangerous in so far as they have a static approach to financial services. As far as the second mortgage market is concerned and, especially in its transposition in the member states, the Directive covers two quite different areas of „consumer“ credit, namely instalment credit and mortgage loans (and even more if leasing and credit card credit is considered). Every compulsory listing that does not specify the market segment to which it should apply deviates from this philosophy.

• Finally, the Directive refers to the consumer credit market and to standard products. It does not impede the development of new products but on the other hand refers directly to an economic view of credit, conscious of the fact that mere legal definitions which are in the hands of the suppliers would otherwise „derogate, to the detriment of the consumer, from the provisions of national law“.
B. The Interpretation of the Directive as far as cost elements are concerned

On the basis of this philosophy price disclosure through the APR requires a normative definition about those elements in the payment of a borrower that are connected with the credit.

1. General Definition of Cost Elements
   
a) Art. 1: Definition for Disclosure

Art. 1 of the Directive defines the cost elements as follows:

(d) "total cost of the credit to the consumer" means all the costs, including interest and other charges, which the consumer has to pay for the credit;

(e) "annual percentage rate of charge" means the total cost of the credit to the consumer, expressed as an annual percentage of the amount of the credit granted and calculated in accordance with Article 1a."

In respect of the elements to be included in the APR calculation, Article 1(2)(d) of the Directive is drafted in wide terms with a specific focus on credit in general and its economic structure. Referring to "credit to the consumer" the Directive does not adhere to a traditional specific definition of consumer credit as for example instalment credit and supports the economic approach in market comparison.

(1) "Annual Percentage Rate of Charge"

The "total cost of credit" encompasses all costs payable "for the credit". The wording of the clause is seeking to provide an inclusive and wide definition. "All costs" is qualified - without prejudice to its generality - by reference to "interest and other charges". With the reference to an "Annual Percentage Rate of Charge" interest is viewed itself as a charge making up the total cost of credit and therefore all cost elements are defined as charges. It is important to note that the Directive expressly includes interest into charges ("other charges") which makes it clear that the denomination of the Annual Percentage Rate of Charge does not refer to the traditional view of interest as a time-related price only.

This intention of the Directive has been flawed by a form of translation that tried to incorporate national habits and understandings. While the UK version of the Directive correctly and constantly refers to the "Annual Percentage Rate of Charge" and also to "charges" where the total cost are addressed, the German version translates this into "Effektiver Jahreszins" (EffJz) which, in English would read: "effective annual interest rate". It therefore assumes that all charges can be called "interest" - which has resulted in misunderstanding.

The phrase "Annual Rate of Interest" also appears in the UK version of the Directive but in Art 6 it correctly denominates interest in the traditional sense because Art 6 alinea 1 refers to "the annual rate of interest and the charges" making it clear that this is not the APR and interest is only a part of its charges.
The German version instead refers to „interest“ and „cost“. The German Consumer Credit legislation even contains the word „interest rate“ twice in Art 4 with different meanings: once with respect to the total charge and the other time with respect to time related cost elements of the credit. In the German legal language, if the time related cost elements are at stake such charges are described with „interest in the sense of the Civil Code“.

The French translation of Art 1 of Directive 90/88/CEE uses the words „le taux annuel effectif global“ which means the „inclusive annual effective rate“ (TEG) and further refers to the „coût total“ or „les charges“ which means „total cost“ and „charges“.

The German version is therefore not only imprecise but perpetuates the problems of a misunderstanding of credit as „lending“ and not as a financial service.

It is to be noted that „Costs“ are not defined and will presumably have their natural meaning. The elements making up „all the costs“ are individually known as charges. Charges include interest charges but are otherwise not defined.

Prior to Directive 90/88/EEC the clause read

„all the costs of the credit including interest and other charges directly connected with the credit agreement. “

Thus „of the credit“ and „directly connected“ were removed - but this was not seen as a substantive revision of its meaning. Nevertheless, it is important to note that the reference to the „credit agreement“ has been replaced by a reference to the „credit“ supporting the general economic approach in the interpretation of the Directive laid down in Art 14.

(2) „the consumer has to pay for the credit."

The reference to payments supports the view that the Directive subscribes to the repayment flow approach instead of the old cash-society approach.

The reference to an obligation of the consumer to pay seems, in fact, to contradict the economic view of credit charges. It seems to be more of a reference to an abstract contractual obligation rather than what is actually paid or what the consumer may choose to pay.

It could be assumed that this wording already distinguishes between obligatory and voluntary payments which are made. Clauses appearing in standard form agreements are usually obligatory to the extent that the consumer can either accept all of them or none of them. In the situation where voluntary clauses appear in a standard form agreement, the way in which they are presented will be important as to construction.

But this view is not consistent with the rest of the Directive. Literally speaking the distinction of cost elements by „having to pay“ does not make sense because certainly consumers will not pay anything in connection with a credit agreement if they are not legally obliged to do so. Eliminating the word „credit contract“ from the reference to the cost elements is accordingly the important part. The total of all
obligations a consumer undertakes in relation to a credit contract is not narrowed down by the credit contract but by the phrase „for the credit“.

Although this purpose is not qualified by any modifiers such as „exclusively for“, as a matter of interpretation the use of the word for must require a direct connection. If a charge is made both for the credit and for another purpose, then this will still be caught as being for the credit.

This form of wording may be compared with alternatives such as „connected to“, which would include all charges that refer to or can be referred to the credit agreement or similarly „in respect of“ or „related to“. These would be wider and encompass charges made which can be traced to the credit agreement in whole or in part.

Accordingly the Directive requires a direct link between the credit and the payments but opens the scope of application by using the word „credit“ which is economically defined by such services which are usually comprised by credit products for the respective customers.

b) Art. 1A: Definition for Calculation

Article 1a reads:

1. (a) The annual percentage rate of charge, which shall be that equivalent, on an annual basis, to the present value of all commitments (loans, repayments and charges), future or existing, agreed by the creditor and the borrower, shall be calculated in accordance with the mathematical formula set out in Annex II.

(1) „all commitments (loans, repayments and charges)“

While Art 1 supports the general assumption that it is not up to a creditor to define in his standard contract terms which cost elements have to be incorporated, Art 1A seems to deviate significantly from this view.

In contrast with the previous form of wording „all costs“, this clause refers instead to „all commitments.. agreed by the creditor and borrower“ which seemingly allows only such obligations which exist between creditor and debtor. This obviously contradicts the list of cost elements the Directive later provides where obligations towards third parties in connection with the credit may count as the „cost for the credit“(especially broker fees).

But this time the English version is misleading. The German version of the Directive refers to

„die gesamten ... Verpflichtungen des Darlehensgebers und des Verbrauchers“
(All of the obligations of the creditor and the consumer)

without limiting such obligations to the contract between lender and borrower which would have required the use of the words „with/mit/avec“ instead of „and/und/et“.
The French version -

*l’ensemble d’engagements... pris par le prêteur et par le consommateur (all of the obligations undertaken by the lender and the consumer)*

even uses a word „engagement“ which does not necessarily point to a legal obligation.

The wording in German and French is also in line with the preamble of this Directive which expresses the exclusive intention to harmonise the mathematical procedure of calculation.

It is noted that although a consumer may be understood to have commitments relating to each of these elements, they are not defined - but nevertheless limit the definition of commitments. Cost elements are all impliedly defined in 1(d) as charges.

„the credit“ is not referred to in this clause and so this qualification must presumably be implied to mean „commitments ... [for the credit or connected with the credit]“. Here, even the narrow terminology „for the credit“ would encompass all elements the consumer agrees to pay for the credit rather than those he may have to pay. It is therefore a definition based on what is paid rather than an abstract legal one.

(2) „in accordance with the total cost of credit to the consumer“

The preamble to Directive 90/88/EEC reads

...it is desirable... in accordance with the definition of the total cost of credit to the consumer, to determine[e] credit cost items to be used in the calculation by indicating those costs which must not be taken into account.

The problem here is that article 1a is not strictly in accordance with the definition of the total cost of credit to the consumer. That article makes no reference to this definition but rather gives the wording described above.

Clearly the intention was for the definition of the APR to draw on that of the total cost of credit but there is inconsistency in the drafting which leads to some uncertainty.

(3) „a statement of the cost items referred to in Article 1a“

Article 4(2)(d) of the Directive requires the credit provider to give „a statement of the cost items referred to in Article 1a“ to the consumer upon completion of the credit agreement.

However, as already discussed, article 1a uses the terminology „commitments“ and articles 1 (2) (d) and (e) respectively uses „all the costs“ and „the total costs“. To be consistent with 1(2)(d) it should refer to „charges“ rather than cost items or commitments.
2. Special Cost Elements: Charges to be excepted

It is a common method of regulation to provide a general rule with exceptions. The following methods have all been used by national legislators to transpose the Directive into national law while the Directive itself has a quite limited approach:

1. The law gives criteria which should be fulfilled if the rule is properly to be applied.

   They may have the character of a legal test or provide a guide to interpretation for the application as is the case with preambles in Anglo-American legislation.

2. Special cases are defined in the law which compel the courts to apply the general rule to such constellations.

   Such case descriptions follow the general rule, mostly introduced by words like „especially“. With such a methodology the legislator attempts to guarantee that certain cases are covered in spite of the possibility that the courts may find different results through the application of the general rule. Such a method has been used especially in standard contract law.

3. Examples illustrating the application of the general rule.

   In this form the legislator doubts that his intention, which in continental legislation is nearly never laid down in the wording of the law itself - and therefore not binding for the interpretation - may be misunderstood. The examples serve as a field where the understanding of the general rule may be explored.

4. Exemptions are made either defined by a second general rule or by specifying cases.

   This may be done either to protect special cases from the application of the rule or in order to clarify the limited scope of the rule. If as, for example, in the US-American legislation on the definition of the finance charge the negative list is only a part of a general listing with positive and negative cases, it contains all the elements of listing in general: examples, purposes, strict application and test.

The Directive has employed exemptions but, as we will see later, within these exemptions there is a hidden positive list where it defines exemptions from exemptions (double-negative).

2. For the purpose of calculating the annual percentage rate of charge, the “total cost of the credit to the consumer” as defined in Article 1 (2) (d) shall be determined, with the exception of the following charges:

This form is obviously the most problematic form in consumer protection legislation. Its purpose is obviously to exempt certain cases and thus to „protect“ suppliers from

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32 A famous historical example in the German civil code is the definition of usury. Article 138 alinea 1 Civil Code voids all contracts which contravene against „good morals“. Alinea 2 defines usury as a „special“ case of such a contravention which has helped historically to develop good morals also into a principle of economic fairness.

33 §226.4 Regulation Z Truth in Lending; This is the basis for the definition of „total cost“ für the US American APR disclosure.
consumer protection. As there is no positive listing to counteract the effects of a negative approach, inherently there are the following dangers:

• Suppliers have the incentive to allocate cost elements under the exemptions inventing constructions which are difficult to penetrate;

• The diversity of exemptions link the meaning of the general rules to factual situations which may change and no longer represent the reasons for their exemption when the rule was made. Implicitly this may change the general rule, especially when all exemptions refer to dynamic parts of consumer credit;

• The incoherence of such exemptions may have important repercussions on the interpretation of the general rule, thus giving the whole rule a quite restricted scope.

The listing seems to have been largely extracted from the USA definition of a finance charge, with the exception that Regulation Z contains a significantly more important positive list of items. The excluded cases in the Directive as described in the following partly clarify the meaning of the general rule but partly contradict it.
Table 11: Listing of Exemptions in the Directive

<table>
<thead>
<tr>
<th>Charges/Products</th>
<th>Negative List</th>
<th>(hidden) Positive List</th>
</tr>
</thead>
<tbody>
<tr>
<td>Default Charges</td>
<td>charges for non compliance</td>
<td>Charges for compliance</td>
</tr>
<tr>
<td></td>
<td>pay whether the transaction is paid in cash or by credit</td>
<td>pay only with financed transactions</td>
</tr>
<tr>
<td>Linked Transactions</td>
<td>transfer of funds and charges for keeping an account intended to receive</td>
<td>(1) (charges where) the consumer does not have reasonable freedom of choice in the</td>
</tr>
<tr>
<td></td>
<td>payments towards the reimbursement of the credit the payment of interest and</td>
<td>matter and where such charges are abnormally high</td>
</tr>
<tr>
<td></td>
<td>other charges</td>
<td>(2) charges for collection of such reimbursements or payments</td>
</tr>
<tr>
<td>Membership fees</td>
<td>(iv) membership subscriptions to associations or groups and arising from</td>
<td></td>
</tr>
<tr>
<td></td>
<td>agreements separate from the credit agreement, even though such subscriptions</td>
<td></td>
</tr>
<tr>
<td></td>
<td>have an effect on the credit terms</td>
<td></td>
</tr>
<tr>
<td>Insurance premiums</td>
<td>(other) charges for insurance or guarantees (if not exempted)</td>
<td>(payment protection insurance)</td>
</tr>
<tr>
<td></td>
<td></td>
<td>death, invalidity, illness or unemployment of the consumer,</td>
</tr>
<tr>
<td></td>
<td></td>
<td>a) of a sum equal to or less than the total amount of the credit together with</td>
</tr>
<tr>
<td></td>
<td></td>
<td>relevant interest and other charges</td>
</tr>
<tr>
<td></td>
<td></td>
<td>b) which have to be imposed by the creditor as a condition for credit being granted.</td>
</tr>
</tbody>
</table>

**a)**

**b) Compliance with the terms of the credit agreement**

(i) charges payable by the borrower for non-compliance with any of his commitments laid down in the credit agreement;

This clause is practically concerned with charges levied where there is payment default and where these are a form of damages for non-performance of the contract. It is drafted widely and does not protect the consumer from punitive charges where there is only a minor breach of contract. Thus, a consumer who agrees to make repayments by direct debit but instead sends post-dated cheques in good time would not have to be told of the effective APR including any extra costs levied for cheque payment.
The logic for not including these charges in the total cost of credit is clear since the credit facility offered to the consumer will be priced at a particular level depending on *inter alia* the repayment terms. The credit provider may suffer excess costs where these terms are not kept to and any variation in the repayment schedule amounts to a different credit agreement.

c) **Cash or credit**

(ii) Charges other than the purchase price which, in purchases of goods or services, the consumer is obliged to pay whether the transaction is paid in cash or by credit;

This clause states very clearly that charges cannot be for the credit if they would be payable were the consumer to pay by cash. However, it excludes the purchase price from the exception which will always form part of the total cost of credit.

d) **Account charges**

(iii) charges for the transfer of funds and charges for keeping an account intended to receive payments towards the reimbursement of the credit the payment of interest and other charges except where the consumer does not have reasonable freedom of choice in the matter and where such charges are abnormally high; this provision shall not however, apply to charges for collection of such reimbursements or payments, whether made in cash or otherwise;

Traditionally the repayment of a loan was the fulfilling of an obligation that was required by the credit provider. Charging for such repayments would, as the German supreme court recently stated when it voided a standard contract term for charging an extra fee for cash repayments\(^\text{34}\), question the right of debtors to comply with their legal duties. Accordingly, in the tradition of credit as capital lending it was unthinkable that debtors would have to pay an extra fee just for being allowed to repay their debts. Extra fees were charged only to those who were in default. In the meantime, credit has developed into a service where the credit provider has more functions to fulfil after the credit has been extended. In variable rate credit and credit card credit as well as in overdraft credit, bookkeeping for the credit includes additional administration when different payments are possible at different times and also additional credit can be taken. Overdraft credit that is inseparably linked to a bank account that facilitates all kinds of payments causes the same payment administration as all other forms of payment. This is why such bookings are equally charged with fees like all other booking or covered by monthly fees. Similar charges occur when credit cards function as debit cards or charge cards linked to a special bank account that gives rise to its own fees.

This section brings fees connected with arranging an overdraft facility outside of the scope of the section, as for annual fees for credit card accounts. It certainly did not want to encourage creditors in traditional instalment credit to levy fees for ordinary

\(^{34}\) Bundesgerichtshof IX ZR 217/95 from May 7, 1996 = Neue Juristische Wochenschrift 1996 p. 2032
repayments that were until now free of charge and whose cost are nearly exclusively covered by the administrative cost element in the interest charged.

To restrict this provision, limitations for exclusion were introduced which have the interesting function of indirectly providing the Directive with a positive list of fees which can help to understand its true purpose.

(1) „reasonable freedom of choice“ and not „abnormally high“

The criteria of „freedom of choice“ is hidden in this minor exemption. As it defines that fees where the consumer has no „reasonable freedom of choice“ have to be included, this gives a clear indication that truth in lending and consumer protection inform the basic philosophy of the Directive. It can generally be assumed that services which are inseparably connected with a credit contract do not offer any freedom of choice. This already follows from Art 81 alinea 1 letter e) Treaty that voids contracts that have been linked to other contracts without this being justified by commercial habits or a specific reason. Accordingly consumers buy such products unconsciously without exercising their market power to influence quality and price. It should be clear from this that if such services are only outsourced, servicing fees which are normally calculated as part of the credit should be included into the APR. But the Directive is not entirely clear.

A lack of clarity is introduced by the use of the word „reasonable“ in the clause. This word is often used in contractual agreements to lessen the potential obligations of a party and refers to what amount to being extra-legal norms such as a „fair in all the circumstances test“. For example, it is usual for credit providers to require repayments to be made by direct debit from a bank account since this is the cheapest form of inter-bank transfer. And it is certain that the customer need not have absolute freedom of choice under the Directive - but whether he should be able to use his current banking arrangements or whether a limited choice of providers - and then how many - is „reasonable“ would be unclear.

What has been achieved by the criteria of „freedom of choice“ seems to be destroyed by the additional requirement („and“) of a fee to be „abnormally high“. This clearly seeks to prevent credit providers from unduly profiting from charges levied in respect of account charges and refers to the usury approach. In addition this terminology is not defined and may presumably refer either to similar charges levied by other providers or to the costs actually borne by the organisation, or both in all the circumstances. In the realm of usury legislation much clearer distinctions are in use, as, for example „double of the average“ (laesio enormis).

But this criterion cannot be understood as anti-usury legislation in the wrong place (payment system services in a Consumer Credit Directive) and with the wrong scope (concerns only linked bank account fees). It obviously assumes that „abnormally high“ fees are the typical result of a lack of „freedom of choice“. Accordingly it serves as a criterion for the statement that there was no freedom of choice. This refers
Harmonisation of Cost Elements of the Annual Percentage Rate of Charge (APR)

precisely to a modern usury approach\(^\text{35}\) in which the lack of competition and bargaining power of consumers is seen as the basic flaw underlying phenomena of overpricing.

But the Directive does not state this clearly enough. It abolishes the main argument of freedom of choice by linking it to „abnormally high prices“. As „abnormally high“ prices always suppose that there was no freedom of choice it in fact is the only criteria which is still valid.

And this assumption is incorrect in the light of simple economics. Lack of choice can be exploited in other ways than through high prices:

- A supplier may offer a qualitatively poor service which is incomparable to other bank accounts because, for example, of its restricted use only for credit purposes;
- A customer may be forced to take an additional service which he or she would not have needed without being forced into it if, for example, they already have one bank account (even with the same supplier);
- A supplier shifts as much cost as possible to the account fee - carefully watching the usury ceilings - as has been the case with US credit card credit which uniformly was at 18% p.a. for a long time period.

The Treaty of Rome put tremendous emphasis on competition and markets. Accordingly it seems strange that in this Directive the freedom of choice is restricted to the prevention of usury.

A more comprehensive understanding of the Article could be that exorbitant prices are only a special case of a lack of freedom of choice. It is submitted that the link between choice and usury should be formed by the word „especially“\(^\text{36}\) instead of the word „and“.

\(\text{e) } „\text{charges for collection“}\)

The inclusion of charges for collection into the APR is an interesting exception to the exception which may have escaped the attention of national legislation. Bank account fees in fixed instalment credit have the sole function of servicing the repayment of the credit. The same is true where in variable rate credit the debtor does not have the right unilaterally to withdraw more money from the account. To this extent the exemption seems only applicable to overdraft credit, credit card accounts and certain variable rate credit contracts but not to the bulk of instalment credit.

Door-to-door sales, including charges which might properly be attributed to collection in the APR will generally result in a high figure. The consumer will be aware that he

\(^{35}\) see Truth-In-Lending, Usury p. 28

\(^{36}\) see FN 32
is using an expensive form of credit and thanks to Article 4 he should also be told that
one, or the primary reason for the high APR is the considerable costs of collection.

This may be not be very helpful where consumers who are denied access to
mainstream consumer credit do not have a choice of provider and will therefore have
little use for the APR in this form.

**f) Group rates**

(iv) membership subscriptions to associations or groups and arising from
agreements separate from the credit agreement, even though such
subscriptions have an effect on the credit terms;

The important point here is that the membership agreements are separate from the
credit agreement. Membership of a group able to access preferential credit terms is
more likely to be a question of status and the marketing activities of credit providers
rather than any displacing of the point of charging for credit.

The consumer faced with a choice of credit offers, one of which may *de facto* require
he join an organisation of some sort will have to weigh up the costs of this offer
separately. This is similar to the exemption for overdraft and credit card account
facilities, all of which may generally impose an annual fee legally, in addition to
quoting the APR under the Directive.

**g) f) Insurance and guarantees**

v) charges for insurance or guarantees; included are, however, those designed
to ensure payment to the creditor, in the event of the death, invalidity, illness or
unemployment of the consumer, of a sum equal to or less than the total amount
of the credit together with relevant interest and other charges which have to be
imposed by the creditor as a condition for credit being granted.

This clause has a quite complicated structure. It starts with a negative item which
does not concern the most common form of insurances connected with credit -
which is credit life insurance - increasingly complemented with other insurances
which cover the repayment capability of the consumer, namely „Payment Protection
Insurance“. Accordingly it contains two different products which are misleadingly
regulated under one general exemption of „insurance“, although the exemption of this
exemption covers nearly all forms of insurance contracts in connection with credit.
But inside this exemption - from the exemption - similar to the account fees, another
exemption is made which in practice again covers all existing payment protection
insurance contracts in Europe. As far as payment protection insurance is concerned,
three time negative results in a negative list.

An important practical element, mixed insurances that contain payment protection, is
not addressed at all in the Directive.
Table 12: Insurance Premium Exemption Clause

<table>
<thead>
<tr>
<th>Insurance</th>
<th>Negative List</th>
<th>(hidden) Positive List</th>
</tr>
</thead>
<tbody>
<tr>
<td>Motor Vehicle and other items that serve as a guarantee insured</td>
<td>All exempted</td>
<td>a) insured amount is higher than the total amount of the credit</td>
</tr>
<tr>
<td>Payment Protection Insurance (death, invalidity, illness or unemployment)</td>
<td>a) insured amount is higher than the total amount of the credit</td>
<td>a) sum equal to or less than the total amount of the credit</td>
</tr>
<tr>
<td></td>
<td>b) offer comes from third person or</td>
<td>b) imposed by the creditor and</td>
</tr>
<tr>
<td></td>
<td>c) freedom of choice</td>
<td>c) condition for credit being granted.</td>
</tr>
<tr>
<td>(Mixed) Credit Insurance (death, invalidity and savings)</td>
<td>?</td>
<td>?</td>
</tr>
</tbody>
</table>

The basic function of the exemption is again to provide criteria under which insurance premiums have to be incorporated.

1. The regulated products

This clause regulates different insurance products which, as the design of products does not lie in the hands of the regulator is in itself dangerous.

The definition covers the main risks covered by PPI. But firstly it does not cover all personal risks relevant for credit failure, such as for example divorce and illness of persons who are dependent on the debtor. Secondly, it does not cover risks inherent in the credit contract itself such as the rise of interest rates in variable rate credit. In mortgage loans there are rate ceilings providing against exorbitant rises of the interest rate known as „rate caps“, which one German court qualified as an insurance product while another qualified it as prepaid interest.

As risk is an inherent part of credit provision the general exemption of risk coverage through third parties seems to be inconsistent with the philosophy of the Directive.

As far as credit insurance is concerned - which is linked by a legal obligation to credit contracts channelling the repayments of the principal into a savings plan connected with a PPI - the Directive is clear as far as the PPI is concerned. Such PPI is obligatorily imposed by the creditor and should therefore be included. But in practice this product is inseparably mixed with a savings plan so that its premium is not known. There is also a general concern in relation to Art 81 alinea 3 and 1 letter e; 82 letter d of the Treaty which voids such contracts that are connected to another product without having a reasonable reason to be linked to the other product.
(2) PPI: „payment to the creditor“

The general exclusion is qualified by terms which carve out what is commonly called payment protection insurance (PPI) as being relevant and to be included in the APR.

PPI can cover all matters which may stop repayments of the loan being made by the consumer - commonly including death, unemployment, incapacity and redundancy. PPI may be confused with life insurance in so far as death of the consumer may result in the discharging of all debts under the connected agreement, the type of insurance commonly required by mortgage lenders. Unlike mortgage insurance (eg. in the UK), it is not thought that consumer credit PPI can easily be purchased otherwise than at the time of making the relevant consumer credit agreement.

In the case of unemployment, PPI will generally make payments under the credit agreement only until the period of unemployment comes to an end or sooner and will not automatically discharge the debt\(^{37}\).

PPI is useful terminology because it describes what the relevant insurance does and, according to the clause is inclusive of all insurances such as more general life or sickness insurance which contain an element of PPI. It insures against credit repayments not being made. Confusingly, variously in German it is known as „Restschuldversicherung“ and in French „assurance du deces“.

(3) Freedom of Choice: „imposed by the creditor as a condition for credit being granted“

PPI is not included in the total cost of credit where the consumer has a choice whether or not to take this out and where the credit will be granted in any event. But unlike with bank account fees this exemption clause uses clear legal language which refers to the commitments of the contract.

"The most commonly used sense of the word “condition” is that of an essential stipulation of the contract which one party agrees is true or promises will be fulfilled. Any breach of such a stipulation entitles the innocent party, if he so chooses, to treat himself as discharged from further performance of the contract, and notwithstanding that he has suffered no prejudice by the breach. He can also claim damages for any loss suffered." \(^{38}\)

"[Conditions] go so directly to the substance of the contract or, in other words, are so essential to its very nature that their non-performance may fairly be considered by the other party as a substantial failure to perform the contract at all"\(^{39}\)

\(^{37}\) „Why worry about the future? You can protect your payments against the effects of life’s unpredictable events. Premiums are calculated each month at just 68p per £100 of your stated balance and protects your payments against the effects of accident, sickness, dying or unemployment. You should be eligible if you are aged 18-64 years, in employment and not aware of any impending unemployment. If you’d like to take advantage of this valuable, low cost peace of mind, just tick the yes box." MBNA Platinum Plus application form

\(^{38}\) Chitty on Contracts Sweet & Maxwell 1994 12-023

\(^{39}\) Wallis, Son & Wells v. Pratt & Haynes [1910] 2 KB 1003,1012 per Fletcher Moulton J
In German the wording is „Zwingend als Bedingung“ and in French „obligatoirement exigé“. It seems quite clear that the regulator did not want to follow the general approach of the Directive in this specific item. In German law a condition is always binding\textsuperscript{40}. In French something which is „exigé“ is equally binding. Therefore introducing the word „zwingend/obligatoiremment“ which refers to „binding“ and „obligation“ underlines that as far as PPI is concerned a legal attitude should prevail.

This break in the philosophy of the Directive as far as insurance premiums are concerned is at the basis of the main problem of its application. Nowhere in Europe are PPI insurance premiums included in the APR calculation although its connection with consumer credit may vary from 2\% of all contracts with one bank to 96\% with another. As a consumer himself has to fill out a contract which will only later be accepted by the creditor (with the exception of France where the consumer has the right to an „offre préalable“) the creditor is free to reject offers where PPI is not wanted. He may indicate that not having insurance will make an applicant less creditworthy and endanger the acceptance of the request. A legal obligation for taking out PPI (with the exception of linked insurance credit) is therefore neither necessary and only known in such mortgage loans where the legislator prescribes such protection as in savings and credit plans.

It is therefore not clear how a consumer is effectively protected where credit providers are de facto free to persuade the consumer to take out PPI as long as legally it is not imposed as a condition. Whether PPI is a good or bad product is largely irrelevant to this analysis but it does seem as though there is tremendous scope for credit providers effectively to market PPI under the Directive.

3. Summary: „Cost of the Credit“

- The Directive’s purpose is to identify those payments of the consumer that may be attributed to the credit itself. (payment flow)

- The Directive is ambiguous on whether legal or economic criteria should prevail to establish the necessary relationship between a special service and its cost with the credit contract and its payment.
  - The general definition as well as the prevailing philosophy of the Directive, as expressed in its preamble, Article 14, in the description of the calculation method and the criteria for omitting account fees, are based on the statement of an economic link between credit and the other service as necessary and sufficient.
  - The amendment of Article 1A in 1990 introduced, apparently without the intention to change anything, a legal wording of contractual commitments which especially affects the classification of Payment Protection Insurance as credit cost or not.

\textsuperscript{40} Article 158 German Civil Code reads: „Wird ein Rechtsgeschäft unter einer aufschiebenden Bedingung vorgenommen, so tritt die von der Bedingung abhängig gemachte Wirkung mit dem eintritte der Bedingung ein.\”
The form of a general clause with a negative list of exemptions which mainly
orientated to products and not at the link between such products and the credit is
inappropriate.

- The list of exemptions is basically a positive list in so far as exemptions of
  the exemptions are regulated.

- Some exemptions contain general criteria as to the quality of the link
  between the additional service and the credit.

- The list of exemptions is somewhat arbitrary as it does not cover all forms of
  a product (eg. PPI) and not all items which do not fall under the general
  definition of credit cost.

The Directive would be much more precise if only one regulatory approach were to
prevail and if positive and negative lists would be separately introduced by a
general principle so that the items could serve as examples.

The Directive should:

- concentrate on different services and their definition as part or not as part of
  the credit service adapting the payment flow approach which would make
  the method of calculation consistent with the legal definitions;

- apply an economic language where the aim of consumer protection is
  apparent. This could encompass the notion of „linked services“;

- concentrate on „freedom of choice“ (not usury) and „transparency“; and

- make lists of clearly positive and clearly negative items to define linkages,
  but should also provide a list where additional criteria alone decide on its
  inclusion.

C. Implementation into National Legislation: Conclusions

The information received from member states is evaluated and represented by the
author in Annex 1 of this report partly in English and partly in the French language.
The following chapter tries to draw conclusions from this material.

The author has reverted to three different sources:

- a written request for information together with a questionnaire (see Annex 5) sent
  to the members of the expert group through DG XXIV

- the same request sent by IFF to consumer organisations or consumer research
  institutions in France, Belgium, the Netherlands, Finland, United Kingdom,
  Germany and Italy.

- Personal visits by project collaborators to the UK, France and Germany with
  interviews with bankers and consumer organisations
1. General Observations

The amount of material available concerning the application of the Directive depends largely on whether Member States have special bodies for the implementation of such rules. In the UK and Ireland the respective Offices of Fair Trading are quite active in this area and in France special councils are in charge of interpretation and through their connection to usury law the courts are quite active.

In most countries the government agencies concerned with APR have replied to the request with a reference only to legal material. With the exception of Austria and the UK it seems that the practice of its application is not monitored on a regular basis. With the exception of France, in no country do the courts play a visible role in the application of this Directive and it seems as though there is a legal discussion on one hand among lawyers and regulatory bodies and on the other hand a practice where the suppliers sometimes criticised by consumer organisations define how the rules are really implemented.

This polarisation has existed until now. This may change if, like in Germany sanctions are provided which give consumers a benefit in case they detect an incorrectly calculated APR in their credit contract. But even in Germany where consumers can claim the difference between the true APR and the disclosed APR no jurisprudence has been made public until now.

Therefore the Directive and the respective legislation in most countries serve more as a guideline than an obligation. As competition is a quite important factor for the implementation of such „soft law“ this must not necessarily hinder its efficiency. The viewpoints outlined and the multitude of items enumerated in national rules make clear that there is still a lot of confusion about what should be really included in the APR calculation.

We will see in the practical part of this report that the legal diversity of its implementation does not really affect practice which is much more homogeneous than the legal situation may assume.

Most countries simply draw from the basic idea of the Directive, even its wording. Only some of them try to clarify the meaning by giving more examples than the Directive itself contains. Member State law does not visibly deviate from the Directive. However, the examples which are given in addition to the Directive by regulations may be questionable in some instances. But in this respect the national specificities may often hinder such critique if, for example, such cost elements do not exist in this form in other Member States.

It seems to be problematic but in line with the Directive’s approach that all countries either confer the definition of most of the cost elements primarily to administrative bodies (Germany, Italy, Belgium, United Kingdom) or leave it to the discretion of the courts.

The Dutch Office of Fair Trading have forwarded information that seems to deviate substantially from the situation in other countries as far as insurance premiums and bank account fees are concerned. But the APR regulation in the Netherlands is
governed by the rate ceiling regulation in this State. Besides the introdutionary statement which assumes that such fees are normally included or inexistent seems to deviate from the wording under 5. where the legal situation does not significantly deviate from the situation in other countries. The author therefore doubts about the practical difference in the Netherlands. But with the limited resources of this project it was not possible to verify the given information because, firstly, the substantial amount of Dutch regulation did not permit its translation and secondly, that no empirical information on credit contracts in the Netherlands was available. We therefore reproduce the commentary we received:

According to article 34 of the Dutch Consumer Credit Act (CCA) only three credit payments are allowed. This article states:

- the credit institution or the merchant is prohibited to ask, to bill or to accept any credit repayment except:
  - the credit repayment that has to be paid according to the contract;
  - payment made when a debtor, after being declared in default, still is not paying;
  - payment where the debtor pays the balance in advance.

Where a credit institution requires a client to have a bank account with that institution, no fees are allowed (article 33, first section, under b, second part).

The question whether a „cost“ is connected with a credit is hardly an issue in the Netherlands. Costs that also have to be paid where a good is bought without credit because those costs are not credit related are excluded from the APR calculations. Discussions on this matter are rare. In this respect a quotation from the explanatory note to the CCA: „Bij de vaststelling van het maximum tarief zal worden uitgegaan van hetgeen thans gebruikelijk is in de branche, dat wil zeggen inclusief overlijdensrisico- en exclusief arbeidsongeschiktheid,-, werkloosheids- en andere verzekeringen. Will de kredietgever deze laatste extra diensten in zijn credietaanbod opnemen, dan is dat derhalve toegestaan, mits hij het ingevolge artikel 35 vastgestelde maximum niet overschrijdt.“ („By calculating the maximum APR used on the market, credit life insurance premiums are included but incapacity to work and unemployment insurance premiums are excluded. If the grantor wants to offer the latter together with the credit he may do so provided that the maximum rate fixed by Article 35 is not passed.“ UR)

5. According to article 50 (see annex 4), a service or a product may only be a collateral for a credit if this service or good is paid for with the loan. Where a credit institution requires a package, for instance insurance, the client has the right to choose the insurer. In this case the costs are not included in the APR. As far as I know only the obligation by law to insure a car is sometimes also mentioned by a number of credit companies. Furthermore, a number of credit companies offer insurance „for free“ containing the provision that the debtor does not have to pay the balance of the loan in case of his demise.
2. Link between Credit and Cost

All countries have a general clause defining which cost elements have to be included or which services have to be seen as connected with the credit in so far as their fees should be seen as credit cost elements.

The definitions vary between the two poles of the Directive: a legal link or an economic link.

The Belgian legislation defines the link quite narrowly as „tous les autres frais liés au contrat de crédit“ (all the other costs linked to the credit agreement) and leave it to a Royal Decree to enumerate the items. It is interesting to note that the Royal Decree then refers to „le coût total du crédit“ followed by a number of positive and negative examples.

In addition the criteria of „freedom of choice“ is taken as a general criterion for exemptions - when all exemptions are introduced by the phrase:

„à condition que le consommateur dispose d’une liberté de choix raisonnable en la matière le coût total du crédit ne comprend pas non plus:“

The French legislation puts much more emphasis on the description of economic ties when it states in Article L.313.1 of the Consumer Code :

„sont ajoutés aux intérêts les frais, commissions ou rémunérations de toute nature, directs ou indirects, y compris ceux qui sont payés ou dus à des intermédiaires de quelque manière que ce soit dans l'octroi du prêt, même si ces frais, commissions ou rémunérations correspondent à des débours réels“.

The words „direct and indirect“ for the link between the payments and the service to the credit, the enumeration of three forms of prices („fees, commissions, payments“) and the clarification that payments due or effectuated to intermediaries are included signify a strong commitment to the economic approach in the Directive.

The regulation also makes it clear that the link between the services does not mean that such services are only provided but that also „real advantages“ do not exclude such services from being counted as credit services.

The Finnish law puts emphasis on the economic distinction

*whether expenses etc. concern every customer or credit customers only. Expenses are included on APR if they concern only credit customers.*

Accordingly it states that the additional services remunerated with extra fees can be defined as credit services in the larger sense elaborated above.41

41 see p. 32ff Instalment Credit or Financial Services?
In the explanation of whether a specific cost element should be included or not, the Finnish Office of Consumer Affairs repeatedly uses the word „mandatory“ which describes the link in legal terms.

*If the method of repayment is mandatory under the credit agreement, any charge associated with that method should be included in the APR*

As far as initial fees for overdraft credit are concerned, the office uses the words „directly related“ which in some respect is the opposite of the French wording when it speaks of

*a fee directly related to the provision of a credit product*

Similar to Belgium, the regulation in the United Kingdom determines the cost elements in respect of the credit to administrative rules.

Unlike other countries, the UK’s Office of Fair Trading is constantly monitoring the rules and their interpretation. With its commentary, the OFT subscribes to an economic approach to define the links between additional services and the credit:

The philosophy of the disclosure rules is defined by the consumer protection approach.

*This regulation gives effect to the "inclusionary" principle recommended by the Crowther Report [informing the Consumer Credit Act 1974], that the debtor should be aware of the full cost of the credit.*

Ever wider than the French regulation it makes clear that no legal links nor a mere service function for the credit is a condition for its inclusion.

*Paragraph (b) refers ... to any charge payable under the ‘transaction’. Such a charge need not be related to the credit, directly or indirectly: nor need it be payable to the creditor or of any direct benefit to him.*

The freedom of choice argument is brought forward by the following words which with reference to case law adopt „a wide construction of the words“ in the sense of economic choice:

*A cost incurred entirely the choice of the debtor does not fall within reg. 4, but once a charge is imposed upon him it must be counted in full even if part of it falls, from the creditor’s point of view, outside its purpose.*

*Normally the words „payable under the transaction“ will refer to charges clearly and explicitly imposed upon the debtor. In Huntplast Ltd v Leadbeater, (1993) (CCLR 15) however, the Court of Appeal showed a readiness to prevent possible evasions by adopting a wide construction of the words.*

The Danish as well as the Luxembourg regulations simply use the wording of the Directive.
The same occurs for Italy which adds a positive list which indeed only extracts the positive elements of the Directive’s negative listing (PPI, nominal interest, payments) and adds broker and administration fees. A letter from the Central Bank underlines that the disclosure has the “funzione di informare in maniera sintetica il cliente sul costo del credito, al fine sia di permettergli di conoscere la remunerazione complessivamente richiesta dall’intermediario” (function of informing the client completely on the cost of the credit in order to make him or her conscious of the total charge.)

An interesting definition is given in Austria where the total cost which the creditor charges to the consumer “in connection with the credit taking” (im Zusammenhang mit der Kreditgewährung) is the main criteria.

The exemptions in the Austrian regulations vary from the Directive in that there is no mention of charges other than the purchase price which have to be paid by cash purchasers and the question of membership fees is not raised.

The legal situation as to the link established between the credit and other services may be summarised as follows: most countries just copy the ambiguities of the Directive leaving the question open of how far economic factors may induce a link. None of them restrains such links to purely legal language but the more a country explains and regulates, the more it tends to describe a situation where criteria such as free choice and specificity for credit is taken as a positive criteria. It does this while criteria such as a special benefit from the additional service as well as direct links or the delivery by a third person are rejected.

3. Special products, savings etc.

Where positive lists are used as in Germany, France, Belgium, Finland, Austria, Italy and the UK, initial administration fees, broker fees and nominal interest are listed throughout. France and Austria, which seem to have special taxes for consumer credit (droit de timbre), want them both included into the APR.

a) Insurance

Many of the specific regulations concern insurance. Essentially all countries repeat the somewhat difficult distinctions between Payment Protection Insurance and Guarantees concerning goods purchased by the use of credit. All of them refer the question of the inclusion of the insurance premium to whether the insurance was imposed by the creditor, whether there was a free choice, whether such a product would have been available elsewhere or whether the consumer herself demanded to be insured.

All countries seem to be concerned with the question of how the circumvention of this special exemption for insurance fees can be prevented.

In France the regulation refers to the freedom of taking insurance or not.

Les frais d’assurance ne doivent pas être pris en compte dans le calcul du TEG lorsque l’emprunteur a été libre de contracter ou non une assurance décès - invalidité.
In the listing of the Comité Consultatif du Comité Usagers du Conseil National du Crédit it is even stated that PPI in consumer credit is never obligatory and accordingly not to be included.

la prime d’assurance décès obligatoire (pour le prêt consommation, la prime n’est pas obligatoire et est donc de ce fait exclue du calcul du TEG)

In Belgium, which equally refers to the free choice criteria, a judge of the first instance in Gand has decided that the proof for the free choice lies with the creditor.

In Finland „voluntary“ insurance is excluded.

An interesting reversal between PPI and guarantees seems to be made by the Irish Office of Fair Trading.

"Charges for guarantees / extended warranties should be included when mandatory on the granting of credit. Please note however that in relation to Mortgage related insurance that charges for insurance on the life of the borrower or for insurance against property damage are excluded from the APR calculations"

The most sophisticated enumerations stem from the UK Office of Fair Trading.

It excludes

(g) a premium under a contract of insurance made before the debtor applies to enter into the agreement;

(h) a premium under a contract of insurance in respect of risks relating to the use of a motor vehicle;

(i) a premium under a contract of life insurance where the policy monies payable under the contract are, under the transaction, to be used for the repayment of the credit [under the agreement or under any other personal credit agreement secured by a land mortgage forming part of the transaction] or of the total charge for credit;

(j) a premium under a contract of insurance the making or maintenance of which is not required by the creditor as a condition of the making of the agreement;

(k) a premium under a contract of insurance against loss of, or damage to, land or to land and goods, being a contract which -

but then narrows its effects down by requiring additional criteria which circumscribe the „freedom of choice“ argument. It is reproduced because it seems best to represent the general assumptions about freedom of choice as far as insurance contracts linked to credit contracts are concerned:

Insurance premiums have to be included
(i) where provision of substantially the same description as that to which the arrangements or contract of insurance relate is available under comparable arrangements from a person who is not the creditor or a supplier or a credit-broker who introduced the debtor and the creditor, and

(ii) where the arrangements or contract of insurance are made with a person chosen by the debtor, and

(iii) if, in accordance with the transaction, the consent of the creditor or of a supplier or of the credit-broker who introduced the debtor and the creditor is required to the making of the arrangements or contract of insurance, where the transaction provides that such consent may not be unreasonably withheld whether because no incidental benefit will or may accrue to the creditor or to the supplier or to the credit-broker or on any other ground;

In the UK example the product where insurance is linked with a credit contract so that the principal of the credit shall be repaid by the amount of savings in the insurance contract at the end of the term is generally assumed to be an independent product whose cost shall not be included. The same is regulated in the German rules by the administration of the Laender. But both regulations obviously concern mortgage loans and not consumer credit in the strict sense of the Directive, because the provisions appear among those which refer to mortgages. In any event, in both regulations this restriction to its application is not expressly made so that one may assume that under any circumstances, life insurance or credit insurance linked to a credit contract is exempted without regard to the question whether the insurance was obligatory or not.

Besides all of the different attempts to include at least some forms of PPI, the factual analysis will show that nowhere in the EU are insurance premiums included in the calculation of the APR. All the different legislation and the Directive itself achieves is a variety of statements in standard credit contracts that the consumer takes out insurance “voluntarily”.

b) Account Fees

Account fees are generally exempted but most regulations expressly include such account fees as are hidden fees for the repayment of the credit itself.

Here the regulations differ.

The Office of Fair Trading in the UK clearly restricts the scope of this exemption to current accounts which serve other purposes than just the administration of the credit.

**Reg. 5(1)(f)** In broad terms this excludes bank charges varying with the use of the account. A "current account" is undefined, because both are easily recognised and probably indefinable without introducing uncertainty.

The exclusion refers to "cheques or similar orders". It is submitted that the intention is clearly enough to cover any payment or funds transfer mechanism which can be operated on a normal current account. It should therefore be
unnecessary, for the purposes of this exclusion, to enquire whether the charge relates to a credit or debit transfer mechanism, or to limit the exclusion to paper-based transfers (not all of which would be "similar orders" if a strict view were taken). Nevertheless, with the spread of electronic and telephonic banking facilities of different sorts to the consumer sector, the time may be approaching when the scope and wording of the exclusion should be reviewed.

The Irish regulation reads quite differently, excluding (with the exemption of exorbitant charges)

charges for keeping an account intended to receive payments towards the reimbursement of the credit, the payment of interest and other charges

The Danish regulation also expressly excludes fees for accounts which serve as the target for credit extension, excluding account charges for repayment only.

4) frais occasionnés par la gestion d'un compte destiné aux versements des prestations du crédit, exception faite des frais de recouvrement des versements, que ces versements s'effectuent au comptant ou d'une autre manière.

The German legislation follows the Irish example and exempts charges for accounts irrespective of the purpose of the account but with the restriction of exorbitantly high fees.

Some countries address credit card and overdraft accounts.

In the Irish official explanations credit card accounts as well as overdraft account fees seem to be seen as included into the APR.

Sections 31.2 and 35.1 of the Consumer Credit Act specify particulars to be included and given to consumers in regard to credit agreements operated by means of a credit card or running account. Section 31.2 refers and credit granted in the form of an advance on a current (cheque book) account including an overdraft, Section 35.1 refers.

The Belgian legislation seems to provide that pure credit card fees have to be incorporated. As the Royal decree on usury provides two rate ceilings, one for non inclusive and the other for inclusive credit card credit, it at least assumes that in some cases credit card credit has to recognise card fees as credit cost.

Si la carte à une fonction de carte de crédit, ils doivent l’être. De plus, les arrêtés royaux qui fixent les taux maximales fixent des taux différents, selon que le coût de la carte est inclus ou non. Or, certains prêteurs „jouaient“ sur ces différences en appliquant les taux prévus pour une ouverture avec carte, qui sont plus élevés, mais en n’imputant pas les frais de carte. Le Ministère des Affaires économiques a fait modifier cette pratique.

It further makes clear that mere payment functions of bank plastic cards have not to be seen as services provided with the credit.
4° les frais de carte de paiement ou de légitimation en ce qui concerne les fonctions autres que celles relatives à l’octroi du crédit."

But again the question is of mere theoretical importance. Nowhere in the EU can account fees be traced into the APR calculation. The regulation leaves enough loopholes to define bank account fees as independent from credit contracts despite denotations like credit card account or overdraft account in which the primary purpose of the account is clearly attributed to credit.

c) Other Cost Elements

All countries have made use of the exemptions as far as membership fees, fees for not using the credit, and default charges are concerned. Additional exemptions are made as to post charges ("les frais de port") in the French legislation, to postage and cash on delivery in Finland.

A quite general exemption is made in the English law where obligations entered into before the credit contract was consented to are specially are exempted.

any charge ((other than a fee or a commission charged by a credit broker)) not within sub paragraph (c) above

(i) of a description which relates to services or benefits incidental to the agreement and also to other services or benefits which may be supplied to the debtor, and

(ii) which is payable pursuant to an obligation incurred by the debtor under arrangements effected before he applied to enter into the agreement, not being arrangements under which the debtor is bound to enter into any personal credit agreement;

d) Conclusion

There is a wide variety of regulation concerning special cost elements. The overall effect is that the four exemptions (insurance, membership, bank account, default) of the Directive lead to a de facto situation that none of these fees are included in the APR calculation anywhere in the Member States.

If the Directive is seen simply as a harmonisation Directive to provide consumers with equal information in all Member States, it seems to have worked sufficiently well because the minimum requirements of disclosure are standard in all countries.

If the purpose of the Directive is to further consumer protection in the sense that the consumer gets a true and fair view of the cost connected with a specific consumer credit supply, it falls short.
III. Economic Analysis of the Efficiency of the Directive

Copies of consumer credit contracts have been requested for this project in all Member States. With very few exceptions (UK, Austria) the members of the expert group representing government bodies did not supply such copies or only blank specimen or only mortgage loans. The reason seems to be that they themselves have no access to actual credit contracts in their respective country which is a problem for the effectiveness of the Directive itself. Accordingly, most consumer credit contracts have been received from other sources especially from consumer and debt advice agencies or by personal visits of the team to France, the UK and Germany. Specimens of the contracts have been received from France, Belgium, Germany, Italy, UK, Finland and Austria. As this selection already makes clear that the differences between contracts do not primarily lie in national differences, but rather in the difference between suppliers, the overview seems to be quite representative.

A. Cost Elements in Consumer Credit Contracts - General Observations

1. APR Disclosure and Cost Elements

All contracts reviewed disclose an APR. The APRs had a range from 10% to 30% in all countries while the span was lower on the continent (about 6%) than in the UK (15%).

The typical fees were up-front fees for administration, brokers’ fees, additional information charges and, particularly, various insurance fees. The number of fees varies with the form of the credit. Fixed term credit and linked credit has the highest number of fees, variable rate and overdraft the lowest number.

Excepting insurance fees, all fees seemed to be included into the APR.

There has not been a single case where insurance premiums, bank account fees, default charges or membership fees have been calculated as part of the APR. The same can be said for taxes, which at least were not disclosed as part of it.

Single observations could be made with the following items:

In a German contract a notary fee was disclosed but not included into the APR and it remained unclear for which purpose such fee was levied.

In an Austrian contract concerning mortgages the credit amount was denominated in Shilling but offered for payment in Swiss Francs without precision of the exchange rate.

The following types of consumer credit contracts have been identified:

- fixed instalment credit (Personal bank loan)
• variable rate credit (with credit limits on an account or in the form of a credit card credit)
• motor vehicle loans connected to the purchase of goods
• financial leasing

These forms are basically similar. Some major banks (Citibank, Deutsche Bank, Crédit Lyonnais, Barclays etc.) already offer consumer credit through their subsidiaries in different European countries. But although the general philosophy of these banks is visible through their credit system, the form and style of the contracts is adapted to national requirements and they are not uniform throughout Europe.

2. Form of Disclosure

In research on consumer credit comprising an analysis of thousands of credit contracts in Germany, in 1983 the author concluded that consumer credit contracts are the least standardised forms of contracts in the market. More than 16 different denominations of „net credit” were found and cost elements had been named so differently that an ordinary consumer had no chance of identifying comparable elements.42

The number of items has certainly diminished but the basic statement is still true for the whole of Europe. Unlike in the USA, where a special form is prescribed by law in which suppliers have to enter their cost elements uniformly, no country in Europe prescribes such forms. This is even true for France where the „offre préalable“ forces creditors to inform consumers about the conditions of a contract in advance. An interesting attempt seems to have been made in Ireland where a very comprehensive form entitled „Money Lending Agreement regulated by the Consumer Credit Act” is issued by the Consumer Credit Association, Republic of Ireland. This form meets all the requirements for comprehensive information but its distribution in Ireland is unclear.

Although such forms are not prescribed, there are some banks who are able to offer a comprehensive form while others seem either to be interested in hiding cost elements or just do not care for their disclosure.

Some banks offer computer print-outs with little or no design concession to present the information. While their advertising shows how disclosure of elements could be structured, the contracts themselves are often incomprehensible.

The following items are not exceptions but qualify a significant amount of contracts in all states:

42 see Reifner, Ratenkredite an Konsumenten, Project Report Ministry of Justice, Verbraucher-Zentrale Hamburg 1983
Table 13: Problems of Information in Credit Contracts

| APR – Disclosure | Although all contracts contain the indication of the APR it is quite difficult to detect which interest rate shall represent the APR. It is normally written in the same form as other interest rates and therefore disclosed together with a nominal yearly and a nominal monthly interest rate (France), the „interest rate“ (UK), the rate for credit cost (Germany) which is also given as a monthly (calculated without concern for the decreasing amount of the credit) rate. |
| Verification of the APR | The verification of the APR is extremely difficult because no contract explicitly states which cost elements have been used to calculate the APR. This is especially true if insurance premiums are financed together with the credited amount (Germany, UK, Finland, Austria). In this case the „interest“ calculated with the nominal interest includes those for the insurance premium. Also the capital is inclusive but obviously not used for the APR calculation. |
| Difficult to Read | The computer prints cost items in the wrong place - because the paper had not been put properly into the printer. The printer had a worn out ribbon so the numbers are difficult to read. The consumer receives a copy produced by carbon paper which again is difficult to read. Text is overwritten by the printer or even a typewriter, or part of the text is crossed out in a way that other text is also affected. |
| Mixed with other Information | Personal data of the consumer is mixed with data concerning the credit contract. Important information is hidden in the fine print on the second page. |
| Abundance of Information | Some credit contracts contain several offers and up to five different APRs (France) which, only in connection with the numbers and amounts inserted above, can be identified as the true APR. The number of individualised information on the first page varies from about 70 in one contract to 14 in another. (UK) |
| Lack of Information | In some contracts insurance cost is not visible in the credit contract itself but only if a copy of a special insurance contract is added (which was not always the case). (Germany) In any event a calculation of the instalment made clear that such insurance must have been part of the contract. In an Austrian contract additional car insurance was printed in the contract with a stamp and filled out by hand which disclosed the increased instalment and the net insurance premium (which was obviously financed.) Quite often it is unclear which insurance is sold. In one English contract it was even required of the consumer to calculate whether the premium was more than 13% of the cost. In this case it would also cover unemployment. German contracts do not expressly state that the insurance premium is part of the financed capital. An English contract made this an option but, as quite often, such options lack a cross but are applied in any event. In |
### Information

<table>
<thead>
<tr>
<th><strong>Unclear Information</strong></th>
<th>In an Austrian form three different instalments are indicated. The denomination of the insurance product is often unclear about who is insured and what is insured.</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>No Specified Information</strong></td>
<td>While fixed instalment credit has the most individualised information, variable rate credit and credit card credit restricts its information mainly to the credit limit, the initial APR and the minimum instalment. All other information is hidden in the extremely sophisticated regulation of the standard terms.</td>
</tr>
</tbody>
</table>

### 3. Calculation of the APR

The calculation of the APR poses no mathematical problems. The overall finding was only that the French method of APR calculation still discloses in the respective contract a significantly lower APR than the other countries do.
B. **Insurance Fees**

1. **Types of Insurance**

By far the most important cost element that is not included into the APR calculation is the insurance premium.

There are basically three types of insurance\(^{43}\) extended in connection with a consumer credit contract and which are treated completely differently as cost elements in credit contracts. The following table gives an overview.

*Table 14: Insurance connected with Credit*

<table>
<thead>
<tr>
<th>Other Denominations</th>
<th>Payment Protection Insurance</th>
<th>Guarantee Insurance</th>
<th>Credit / Life Insurance</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Type</strong></td>
<td>Risk Insurance</td>
<td>Risk Insurance</td>
<td>Savings Plan (with risk life insurance)</td>
</tr>
<tr>
<td><strong>Insured Risk</strong></td>
<td>death, sickness, accident, incapacity to work; unemployment.</td>
<td>theft, destruction, accident for cars; depreciation of land</td>
<td>death</td>
</tr>
<tr>
<td><strong>Relation to Credit Services</strong></td>
<td>Replaces Part of Credit Risk</td>
<td>Raises Value of Security</td>
<td>Replaces Repayment</td>
</tr>
<tr>
<td><strong>Payments</strong></td>
<td>included in instalments</td>
<td>Included as well as extra</td>
<td>separately charged but paid in one instalment</td>
</tr>
<tr>
<td><strong>Premium financed?</strong></td>
<td>mostly (not France)</td>
<td>no</td>
<td>no</td>
</tr>
<tr>
<td><strong>Product as such available without credit on the market?</strong></td>
<td>no</td>
<td>yes</td>
<td>yes</td>
</tr>
</tbody>
</table>

---

\(^{43}\) Especially credit cards also connect other insurance like for example „travel insurance” (60.- DM per year) and „guarantee insurance for purchases” (12.- DM per year) but such insurances are obviously not linked to the credit but to the payment function of such cards and are therefore not treated in the context of this report.
2. Payment Protection Insurance

a) Appearance

All consumer credit contracts provide for the possibility of taking out payment protection insurance. About 15 years ago credit life insurance was the only credit insurance product extended by banks serving low income customers. On the death of the consumer, her estate would be liable for the debt and there could be an assignment of the proceeds to the credit provider to the amount outstanding. There is generally no primary purpose provision.

A German survey in 1986 showed that only 3% of savings banks undertook instalment credit (60% of the market) but 93% of consumer credit from providers was insured. There has been an extensive discussion in the German legal community whether such premiums should be included into the APR - for the usury test. The Appeal Courts were split over this question, ranging from full inclusion to no inclusion. The Supreme Court finally decided that these costs represent a service to the bank as well as to the borrower and his or her family so that half of the premium should be charged to the credit.

About 10 years ago a second type of insurance appeared covering the risk of illness and incapacity to work. This insurance has now spread all over Europe and has been integrated into one product, especially in France and the UK. This insurance covers illness and accident but only if the reason for such illness was not already given before the credit contract was concluded.

At first in the UK and now also on the continent, unemployment and redundancy insurance for forced unemployment of people who are in work and are not already aware of their job loss at the time when the credit contract is concluded is connected to the credit contract.

The cover of such insurance varies and all combinations are possible. Usually the elements of insurance build up on each other. Illness insurance never appears alone but in connection with life insurance and unemployment insurance, regularly with both. It may be observed that a pyramid defines the creditworthiness of a consumer and then attributes the different insurances to his or her contract.

But in some countries it may still be developing. The Finnish report states:

> These kinds of insurances (PPI UR) have been offered for approximately five years and they are still relatively rare. There are only three companies in Finland which offer this type of insurance. Regarding the prices, the Finnish Insurance Ombudsman Bureau will in the near future do a report comparing prices of credit insurance and other life insurance. At the moment it is not possible to give any useful information on the prices.

b) Structure and Relation to similar Insurance Products

PPI covers the outstanding debt in the credit contract when the debtor dies or is unable to pay because of an insured event.
If, for example, a credit advance of 10,000 ECU is insured with PPI, if the consumer dies on the day when the credit was extended the bank receives a total payment of the debt of 10,000 ECU on this day from the insurance company. In the middle of a running agreement with 2,000 ECU fees for 40 months there are still 20 instalments of 300 ECU = 6000 ECU outstanding debt which are covered by the insurance. This is indeed more than is needed because the consumer has the right of refund of the unused interest which may rise to 512 ECU, so that only 5487.80 ECU should be covered. For the reason of simplicity, most PPIs calculate the curve in a linear modus so that consumers are slightly over-insured.44

A consumer could have the same effect if she were to take out ordinary life insurance on the open market and assign that part of the payment in case of death to a creditor to cover the outstanding debt. But such insurance is bought for a long time and not offered in the form of a decreasing amount. This would not hinder the use of inexpensive life insurance available on the market.

If for example a 30 year old person were to take out life insurance for the rest of her life, the annual fee for insurance covering 50,000 ECU - constantly - would be little more than 50 ECU. This insurance could be assigned to all potential creditors in consumer credit as far as there is outstanding debt. In the event of death the bank would get the outstanding amount paid while the family of the insured would receive the rest. The advantage of such insurance would not only be that it is more then four times cheaper than credit connected life insurance and that it would provide extra coverage for the family but also that it would not have to be taken out each time a new credit agreement is entered into. The increase in premiums with increasing age would be prevented.

But even if consumers were aware of these advantages the bank would not accept a mere assignment of this insurance in exchange for credit life coverage because, especially with mortgage providers where consumers may try to use this better facility they argue they need confirmation from the insurance company that this sum will definitely be paid to the creditor in case of death. The insurance company will not

44 In Germany there is still a legal speciality in so far as only 80% (inability + life) or 60% (life) of the outstanding balance is „legally“ covered. But as life insurance pay so-called „Überschüßbeteiligungen“ (participation at the surplus) the true amount covered is 100%.
give this certificate because it can not be 100% sure that the consumer did not assign this insurance to a third person first.

The insurance industry would accordingly have to offer generally unassignable life insurance products which can only be assigned with the special consent of the insurance company. Such products are not offered on the market. This is why in practice general life insurance does not function as an alternative to credit life insurance.

If one were to compare such insurance limited to a decreasing risk with ordinary life risk insurance, the following deviations may be seen to distinguish this product from other risk life insurance.

Table 15: Credit-connected life insurance and general life insurance compared

<table>
<thead>
<tr>
<th></th>
<th>Credit life insurance (PPI)</th>
<th>Risk Life Insurance</th>
</tr>
</thead>
<tbody>
<tr>
<td>insured risk</td>
<td>death (sometimes of co-signer or both)</td>
<td>death</td>
</tr>
<tr>
<td>purpose</td>
<td>Repayment of the debt</td>
<td>all purposes</td>
</tr>
<tr>
<td>amount</td>
<td>low amounts</td>
<td>typical minimum: 50.000 ECU</td>
</tr>
<tr>
<td>beneficiary</td>
<td>Insured person</td>
<td>creditor</td>
</tr>
<tr>
<td>time period</td>
<td>limited to the life time of the credit contract (or its cancellation or refinancing)</td>
<td>up to 60 years of age</td>
</tr>
<tr>
<td>marketing</td>
<td>Bank</td>
<td>insurance company</td>
</tr>
<tr>
<td>assigned</td>
<td>Irrevocably to the bank</td>
<td>free</td>
</tr>
<tr>
<td>cost</td>
<td>1.20 per 1000 per month = 312 ECU</td>
<td>50 ECU</td>
</tr>
</tbody>
</table>

It is to be noted that such insurance is also sold to highly indebted single persons, where no one would benefit because, of course, debt cannot be inherited.

A similar table may be drawn for insurance concerning the incapacity to work and illness. The typical differences are the same as with life insurance because such insurance is mostly taken out for long periods and used by the insured person at his or her own discretion. In addition, a short term is especially undesirable with insurance against illness because most incapacity to work stems from work related illnesses whose chronic nature is not covered by short term insurance contracts.

As for unemployment insurance, there is no significant offer of such products on the market. Recently the Volksfürsorge Insurer in Germany launched insurance for
unemployment which gives a limited period of coverage for the difference between
the old income and unemployment benefits. As this insurance has so many
restrictions (grace period after dismissal, minimum work period before, limitation of
payment) it has been widely seen as inadequate for people threatened with
unemployment in Germany.

In addition to illness and unemployment insurance there is less reason to link this
solely to a credit contract because the debtor is still able to decide on its own in case
of such crisis how to distribute his or her income.

c) Cost

(1) Financed and Cash Premiums

PPI is provided in two quite different forms: as an additional cash price made with
monthly or annual payments of the premium as well as an up-front premium that
pays the advance the premium by up to 120 months.

In France, PPI is generally sold like all risk insurance available on the market with
monthly payments. But in all other countries, PPI is charged as an up-front fee where
all future premiums are due immediately. This is also true for credit contracts of more
than 10 years. In the UK, some contracts offer the choice between a premium to be
paid together with the instalments and an up-front fee, but none of the contracts
submitted take this approach.

For Belgium the following information about PPI-premiums with high charges, as is
common practice in other countries, was communicated by test achat with the remark
that such practice would certainly be abusive.

Il faut savoir que certains courtiers n’hésitent pas à vendre au consommateur
une assurance de solde restant dû à un prix prohibitif en prélevant le montant
de la prime (unique) sur le capital emprunté (on a cité des exemples de primes
de 10 à 20 % du montant emprunté). Il s’agit de pratiques abusives très difficiles
à contrôler.

Charging insurance fees for PPI in advance gives the bank the opportunity to finance
this amount. Thus the total insurance premium creates initial fees as well as interest.
Thus, banks earn the equivalent of the different between present and future value of
the insurance premium. The insurance company has the advantage of getting the
payment before the risk period occurs, saving collection and administration cost as
well as the risk of insolvency.

Another advantage for the insurance industry is the possibility in cases of early
repayment to reduce the refund. With early cancellation, the insurance company
does not refund the true outstanding part of the premium, which for example, is
calculated in the USA with the same rule of as for outstanding interest.

Assuming that insurance premiums are not comparable to fees and interest
advances they can refund only the so-called „re-purchase-price“ of the insurance. In
this price, the initial provision is already deducted and lost and special arrangements
by the insurer which favour younger over older customers disadvantage the re-
purchase price so that the refund always includes a loss in premiums which may add up with more refinancing arrangements. As there are banks which have specialised on a global scale in refinancing credit contracts as often as possible (16 contracts in time periods of less than 10 years are quite normal), in order to profit from the various refund formalities, low-income consumers are particularly burdened.

(2) Structure of an Integrated and financed PPI Product

In addition to a finance charge, banks acting as insurance brokers earn significant commissions offered by insurance companies for selling their products. There is little knowledge about the amount a bank earns through such contracts. In credit life insurance the commission is generally 3.5% of the insured amount - which seems to be high for risk insurance. But, as the effort a bank has to undertake to sell such an insurance contract is marginal, each provision adds almost completely to the net profit of the credit.

The cost structure of PPI is therefore as follows:

Graph 2: Cost Structure of PPI

<table>
<thead>
<tr>
<th>RECEIVER</th>
<th>COST ELEMENTS</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bank</td>
<td>Finance Charge (not in France)</td>
</tr>
<tr>
<td>Bank</td>
<td>Bank Provision</td>
</tr>
<tr>
<td>Insurer</td>
<td>Administration + Profit</td>
</tr>
<tr>
<td>Insurer</td>
<td>Risk Coverage</td>
</tr>
</tbody>
</table>

- In most instalment credit contracts the basis for the calculation of the PPI-premium is either not indicated or difficult to verify.

- Only the total amount of the premium is indicated in the contract. For the finance charge there is no indication of the absolute amount of the part of the finance charge for the PPI. The total amount of the PPI premium is simply added to the principal before administration fees and nominal interest are calculated on the basis of this „net credit“. This form of calculation has the important disadvantage that for most consumers, the true amount of the net credit is obscured. Interest is not calculated on what they receive but rather on an amount which derives from cost calculations of the bank. The advantage of this form of calculation lies in the fact that the interest charge and the administration fee concerning the insurance premium is included in the APR.
• Some credit contracts reproduce tables on the back in which the premium is explained. Such tables generally show that the premium for life insurance connected with consumer credit is lower for women than for men and that the premium rises mostly within periods of 4 years of age. For example, the PPI premium for a man 50 may be quadruple that for a 45 year old.

• Some banks separate credit and insurance contract totally from each other, although the figures are on the same contract and all contracts are signed with one single signature covering the credit contract, the insurance contract and the credit contract for the insurance. In this case the finance charge for the insurance is not included in the APR.

• In variable rate credit and particularly credit card credit with varying outstanding balances, the insurance may also be calculated as a fixed sum and debited to the account assuming that the amount of the credit initially agreed together with the minimum instalment to be paid indicates the amount to be insured. But generally the insurance premium is simply debited from the account on a monthly basis, calculated on the outstanding balance according to various parameters. Such parameters are as follows:
  
  • 0,54 % of the outstanding credit amount per calendar month (France)
  • 30 FF pcm or 50 FF pcm or both (France)
  • 0,35 % of the balance (France)
  • 13% of the Loan Facility (life insurance for both borrowers) and accident, sickness and redundancy cover for the first signatory
  • the monthly premium is 7% of the repayment for the first 12 months and 11% of the repayment over 12 months and up to 36 months (UK)
  • 8,19 pence per £1 of standard monthly repayment except upon final repayment (UK)
  • 0,79% of the monthly credit card account balance (Germany)

In a UK contract the following explanation could be found in the fine print „explaining“ what the charges were for:

Where "Credit Life Insurance" is requested then this will be effected on the first two named parties listed under the "Borrower(s)" in the Schedule. Where "Payment Protection Insurance" is requested then if the Premium is up to or less than 13 % of the Loan Facility the cover effected will be life cover on the first two named parties listed under the "Borrower(s)" and accident, sickness and redundancy cover on the first name party listed under the "Borrower(s)". If the Premium is in excess of 13 % of the Loan Facility then the cover effected is life, accident, sickness and redundancy cover on the first two name parties listed under the "Borrower(s)". Where either "Credit Life Insurance" or "Payment Protection Insurance" have been requested by the completion of a Premium in
sections (B) or (C) of the Loan Details overleaf the Borrower warrants to the Lender that none of the restrictions relating to such insurances apply and authorise the Lender to pay to the Insurers the amount of the Premium. Should the loan be repaid early, the cover continues for the remainder of the insured term - therefore in the event of redundancy, sickness or accident occurring after the loan is repaid a sum equivalent to the monthly repayment will be made as if the loan were in existence.

(3) Group Insurance versus Individual Insurance

Quite significant for the cost of PPI is the question whether a „group insurance“ or and individualised insurance contract is sold.

„Group insurance“ is sold by insurance companies at a rate of a third of ordinary insurance if a collective – such as, for example an association or a firm - agrees collectively for its members an insurance rate and looks after the administration of the insurance contracts as far as payment and take-up is concerned. As the group rate is fixed by the total amount, the group representative has to pay to the insurance company which again is fixed according to the average risk of such a group, group members normally getting the insurance at the average rate. Accordingly significant savings can be made through group insurance contracts.

On the other hand individual insurance which is much more expensive with the same risk coverage includes various personal distinctions, especially as far as age and sex is concerned. Furthermore, individual insurance has some more other disadvantages which can be summarised as follows:

- The rates increase with the age of the debtor.

- The more a debtor has to adapt her credit contracts to a new situation through refinancing on account of economic difficulties, the more often her rate is raised on account of the increased age.

Creditors have the opportunity to offer group risk insurance at competitive rates because, since they already administer individual insurance contracts, they know all the data about their clients as well as the risks which occur among them - and they would have significant bargaining power.

This is why consumer credit contracts in the USA are all generally sold together with relatively inexpensive group life insurance. Notably there is an submission from the Finnish Office of Consumer Affairs that in Finland, group insurance is offered at quite good rates.

A French form asks the consumer whether she wants to adhere „à l’assurance et à l’assistance collective souscrite auprès du L’UAP collective“ (to insurance and collective assistance underwritten by the insurance company UAP). The effects are unclear and could not be verified with price figures.

Indeed, credit card credit and variable rate insurance looks like group insurance because it is independent of health, age and sex of the borrower and adjustable for
any outstanding balance. It is neither advanced and does not have the problems of refund in early cancellation cases. But the prices seem so exorbitantly high that the question remains why banks in Europe are not able to offer insurance which primarily takes away their own risk for more competitive rates.

The answer may lie in the significant opportunity for banks to earn money in selling insurance as well as in the special European structure where banks are allowed to own insurance companies or at least to have a significant influence on them.

(4) Empirical Survey in Germany (CALS Data)

The true cost of the insurance package linked to credit contracts can only be discovered through empirical surveys. For this purpose IFF has developed computer programs which are used in all German consumer centres for credit counselling. As the calculation of the APR may state that a credit is usurous or that an incorrect APR gives a right for refund, many consumers go to these counselling agencies who charge little or nothing. The data of the credit is entered and recalculation of the credit as well as all kinds of analyses are printed out. This programme has also been translated into Italian, French and English with the help of DG 24.

Its general advantage lies in the fact that all data on existing credit contracts is stored permanently in the programme and may be retrieved directly by any of the standard data evaluation programmes. Such data could be used by the EU and by national bank authorities to monitor the application of the Directive. But even for consumer organisations there has been little demand to evaluate such data - and the consumer organisations are reluctant to offer this data.

The following data has been retrieved from the records of a single consumer centre, namely the Hamburg consumer centre. It contains data concerning 1078 credit contracts adding up to a total of 17 million ECU divided among instalment credit, variable rate credit and credit life insurance. Each data set contains about 30 elements of data which give information on all cost elements, on the structure of the calculation, on the indicated APR as well as the recalculated APR (by the consumer centre) as well as information about the use of intermediaries, insurance and the part of refinancing in consumer credit.

These contracts cover the last 20 years. 628 out of them were commenced after the Directive came into force but both they do not show significant differences so that the table reproduced below is representative for contracts that have PPI.

The percentage of all contracts (which, according to consumer centres are mostly from consumers with payment difficulties - which again leads to a concentration of customers that have credit contracts with instalment banks) linked to a PPI was 65% in general and for those contracts taken up after the Directive came into force (426/628) 68%.

The percentage the insurance premium made up of the net credit, without regard to the finance charge for the premium was 6%. (the same result appears if only those after the Directive came into force are evaluated.) The average insurance costs were 1.374 DM for all credit contracts and 1716.54 DM for those after 1990.
On average the finance charge for the premium was higher than the premium itself. The PPI including the finance charge made up 23% of all credit costs and therefore increased the burden of consumer credit charges by 1/5th.

Table 16: Survey on 1078 Consumer Credit Contracts in Germany

<table>
<thead>
<tr>
<th></th>
<th>Number</th>
<th>Mean Amount</th>
<th>Net PPI in % of</th>
<th>Total PPI in %</th>
</tr>
</thead>
<tbody>
<tr>
<td>All contracts</td>
<td>1078</td>
<td></td>
<td>65%</td>
<td>65%</td>
</tr>
<tr>
<td>PPI (Life)</td>
<td>700</td>
<td>1.374,78 DM</td>
<td>100%</td>
<td>102%</td>
</tr>
<tr>
<td>Finance for PPI</td>
<td>700</td>
<td>1.401,00 DM</td>
<td>102%</td>
<td>5,766%</td>
</tr>
<tr>
<td>Total PPI</td>
<td>700</td>
<td>80.775</td>
<td>098%</td>
<td>100%</td>
</tr>
<tr>
<td>Net Credit</td>
<td>1078</td>
<td>22.886,32 DM</td>
<td>6%</td>
<td>12,1%</td>
</tr>
<tr>
<td>Total Credit</td>
<td>1078</td>
<td>34.885,43 DM</td>
<td>3,94%</td>
<td>8%</td>
</tr>
<tr>
<td>Total Cost</td>
<td>1078</td>
<td>11.999,11 DM</td>
<td>11%</td>
<td>23%</td>
</tr>
<tr>
<td>Initial Fee</td>
<td>958</td>
<td>530,26 DM</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Broker Fee</td>
<td>59</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Instalments</td>
<td></td>
<td>62</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

d) **Link between PPI and Credit**

(1) **The Credit Contract Forms**

Nearly all PPI is sold directly by including the insurance contract into the credit contract. The customer makes one single signature to take-up such insurance.

Usually on the front page of the agreement there is a small box for credit life or for accident, incapacity to work or for both of them - unemployment insurance gets an extra box.

The consumer is now required to make a cross in a box. This is necessary to purchase PPI - which increases the cost of credit by up to 20%, and which is invisible in the APR. As such forms are normally filled out by a bank officer or a broker, it must be assumed that such crosses are also inserted by the representatives of the creditor and it is nearly impossible to verify how far information has been given to the consumer about cost, advantages (and disadvantages) as well as coverage of the different insurance products linked to the credit contract.

In one case (UK) a bank even reversed this - by making the assumption that a consumer had contracted PPI if she did not make a cross in the respective section. In an Austrian form the clause was stamped into the contract.
But none of the forms offered a separate insurance contract - as signed when people buy risk insurance on the market.

The contracts do not offer sufficient information about the product and the price. It can be assumed that most consumers buy PPI in this way.

The advertising material for consumer credit does not refer to PPI in general. All examples calculated in such advertising leave PPI out. Only credit card companies give some information on the price, but in the above mentioned form which bears no relation to the credit cost, it is difficult to assemble to a real price.

The above cited form of price disclosure was randomly chosen from the credit contracts. They offered nearly as many forms of price definitions as creditors were available. 0.54 % of the outstanding credit amount per month is still the most instructive information one may cite but it is not made clear that this raises the interest rate of the credit by 7.8% p.a. if the premium is debited monthly.

In contrast with this form of inclusion nearly all contracts have a fairly clear statement that this insurance is „optional“.

Mostly this is expressed in the English contract by the word „optional“ in front of the word that is used to describe PPI. In German contracts it seems to be more hidden with words like „abgeschlossen werden kann“ (may be contracted). French forms formulate the respective passage in quite tiny writing as a demand: „Je soussigné .... demande ....“ (The undersigned ... demands)

Another French offer includes the cost for insurance in the form of „assurance facultative“ (optional insurance) and requires a signature at the end of the contract to adhere to „VivAssistance“ which is an additional insurance at 30F per month.

This form of proving that PPI is independently requested by consumers resembles very much the traditional form of declarations where historically the banks informed consumers about their legal position that the credit contract was independent from the purchase agreement so that rights deriving from the latter could not be objected to by the creditor. Such clauses are still typical in credit card agreements. But in all Member States the legislator and courts have declared such information irrelevant as to the factual and objective link between purchase and credit in linked agreements. Article 11 of the Directive 87/102/EEC states that

„the consumer shall have the right to pursue remedies against the grantor. “

(2) Objective Links

There are many factors that link PPI and credit contracts in a more general way which comes quite close to the description of links made in Art. 11 of the Directive as far as the link between seller and creditor is described.
Some banks have their own life insurance companies which offer insurance linked to the credit.⁴⁵

Some major insurance companies own banks.

Nearly all banks have co-operation agreements, exclusively selling the products of a particular insurance company. In these agreements the benefits of the bank are clearly defined if the bank is not directly or indirectly a shareholder.

No bank offers a choice in PPI as to the insurance company. No bank gives any indication of under which conditions currently existing life insurance or any other product bought on the free market would be accepted as PPI.

The products seem to be especially designed for the convenience of the creditor (assigned to the creditor, obligation for advancing the premium so that they can be financed; restricted to one creditor and one single credit contract.)

The insurance is basically outsourcing the risk of a bank. Such risks can be insured by the bank collectively - for example at the German Hermes Insurance Company - at much lower rates.

It is generally assumed that the overall failure rate in consumer credit lies between 1 and 2%. Therefore a general raising of the interest rate by 2% would theoretically allow banks to insure against even total failure. It is hard to understand why the insurance of only small parts of this risk should cost three to twelve times this price.

e) Effects on the APR

For the purpose of calculating its APR, the premium, including the respective credit charges can simply be added to the total of repayments a consumer must make.

In the following scheme, whose tables are reproduced in Annex IV, we show the effect of different forms of PPI premiums on the APR of a credit contract. For this purpose we have chosen an ordinary credit life insurance product with an inexpensive fee of 0.62 per 1000 ECU per month which equates to 0.062% per month. If PPI is used where incapacity, illness and unemployment are included this may amount to a significantly higher degree. In this case, the interest spread between the different APRs according to what extent they are included in the payment flow will be much higher. But already this example shows that the difference of absolute 2% p.a. are so significant that the consumer choice would certainly be affected.

The PPI-premium as well as the finance charge (if premiums have to be advanced) are now calculated in four different ways. In European practice only the first two

⁴⁵ the German Reichsgericht in the 20ties was the first to decide that debtors could pursue remedies against the grantor if the grantor of credit was a „strawman“ of the seller just set up to be able to present to different parties to the consumer.
methods are used by banks. Those banks who charge interest on the premium partly recognise such cost as part of the APR cost elements (most but not all German grantors) while others do not include them (all UK banks and some German banks)

1. PPI is totally excluded

2. Only the finance charge concerning the advancement of PPI premiums and its financing through the bank is taken as a credit cost

3. It is assumed that the PPI is not financed and simply regularly paid with the monthly instalments.

4. The total charge of PPI and its financing cost are taken into account.

We have used the EU formula and an Excel Spreadsheet.
### Harmonisation of Cost Elements of the Annual Percentage Rate of Charge (APR)

#### Table 17: APR Differences with Payment Protection Insurance

<table>
<thead>
<tr>
<th></th>
<th>Without PPI 1</th>
<th>PPI Finance 2</th>
<th>PPI Premium 3</th>
<th>Total PPI 4</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Cash Advancement</strong>*</td>
<td>30.000,00</td>
<td>30.000,00</td>
<td>30.000,00</td>
<td>30.000,00</td>
</tr>
<tr>
<td><strong>Payment Protection Insurance (financed)</strong>*</td>
<td></td>
<td></td>
<td></td>
<td>1.800,00</td>
</tr>
<tr>
<td><strong>Other Insurance</strong>*</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Net Credit</strong></td>
<td>30.000,00</td>
<td>30.000,00</td>
<td>30.000,00</td>
<td>31.800,00</td>
</tr>
<tr>
<td><strong>Broker Fees</strong>*</td>
<td>450,00</td>
<td>450,00</td>
<td>450,00</td>
<td>450,00</td>
</tr>
<tr>
<td><strong>Amount financed</strong></td>
<td>30.450,00</td>
<td>30.450,00</td>
<td>30.450,00</td>
<td>32.250,00</td>
</tr>
<tr>
<td><strong>Interest</strong></td>
<td>17.480,74</td>
<td>18.514,08</td>
<td>17.480,74</td>
<td>18.514,08</td>
</tr>
<tr>
<td><strong>Initial Fee</strong>*</td>
<td>609,00</td>
<td>609,00</td>
<td>609,00</td>
<td>645,00</td>
</tr>
<tr>
<td><strong>other Fees</strong>*</td>
<td>50,00</td>
<td>50,00</td>
<td>50,00</td>
<td>50,00</td>
</tr>
<tr>
<td><strong>Payment Protection Insurance (not fin.)</strong>*</td>
<td></td>
<td></td>
<td></td>
<td>1.800,00</td>
</tr>
<tr>
<td><strong>Total Credit</strong></td>
<td>48.589,74</td>
<td>49.623,08</td>
<td>50.389,74</td>
<td>51.459,08</td>
</tr>
<tr>
<td><strong>Nominal Interest Rate p.m.</strong></td>
<td>0,598%</td>
<td>0,598%</td>
<td>0,598%</td>
<td>0,598%</td>
</tr>
<tr>
<td><strong>APR</strong></td>
<td>14,322%</td>
<td>15,067%</td>
<td>15,618%</td>
<td>16,383%</td>
</tr>
<tr>
<td><strong>Number of Instalments</strong></td>
<td>96</td>
<td>96</td>
<td>96</td>
<td>96</td>
</tr>
<tr>
<td><strong>Regular Instalments</strong></td>
<td>506,14</td>
<td>516,91</td>
<td>524,89</td>
<td>536,03</td>
</tr>
<tr>
<td><strong>Date of first Payment</strong></td>
<td>01.09.96</td>
<td>01.09.96</td>
<td>01.09.96</td>
<td>01.09.96</td>
</tr>
<tr>
<td><strong>Number of Payments per Year</strong></td>
<td>12</td>
<td>12</td>
<td>12</td>
<td>12</td>
</tr>
<tr>
<td><strong>First Instalment</strong></td>
<td>506,14</td>
<td>516,91</td>
<td>524,89</td>
<td>536,03</td>
</tr>
</tbody>
</table>

* Financed; ** distributed evenly; ***calculated on financed amount

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### C. Endowment Policy Life Insurance

1. Mortgages and Consumer Credit - Scope and Appearance
Harmonisation of Cost Elements of the Annual Percentage Rate of Charge (APR)

Endowment life insurance credit as a combined product is in use in most European mortgage markets, especially in Germany, France, UK, Finland, Austria and Belgium. As such, the German APR-regulation as well as the English APR regulation refer directly to this product, excluding payments made on the endowment insurance from its scope in the calculation of the APR of the credit contract. But obviously both administrative regulations have mortgage loans in mind - although this is not clearly stated.

In fact, such products are hardly known in consumer credit with the exception of Germany where a number of banks offer such combinations, stimulated by tax advantages for taking out endowment insurance in Germany. In the following text we will develop the argument of why such a product is misleading in as far as its cost is concerned. This text is taken from a summary of a report delivered for the German test foundation in January 1998 on the question of disclosure of the APR of endowment policy life insurance credit. All of what has been stated in this report (which can be made available to the Commission in the German language)\(^46\) as to the disadvantages is not only true for consumer credit. If the disadvantages occur in consumer credit, they aggravate the situation of the consumer even more. The main reason for incorrect price disclosure lies in the fact that repayments for the credit are channelled into savings for another product. As the debtor is accordingly hindered from paying her credit, the relevant question is - how significant is the difference between interest earned on the savings and the interest paid in the credit and how much amortisation is contained in each instalment.

In both respects, consumer credit is by far more disadvantageous for such a combination than mortgage loans. Whereas in mortgage loans, typically not more than 1% p.a. amortisation is paid per year in the first year, in consumer credit the amortisation is up to 7% p.a. While the span between the return on investment in endowment insurance of about 6% and mortgage loans of 7 to 8% is quite narrow, a consumer who takes out this product together with consumer credit - which may have an APR of 16% - loses 8% p.a. in interest on each payment of a premium.

This is why the German supreme court\(^47\) in analysing such a combination on different occasions in the context of usury has denoted this product as an opaque product which has no advantages but many disadvantages for the consumer.

The court held:

\[ \text{Die Undurchschaubarkeit der Belastung wiegt für den Kreditbewerber besonders schwer, wenn ihm lediglich an der Kreditgewährung als solcher und} \]


\(^{47}\) BGH, Neue Juristische Wochenschrift 1989, 1667.
The court accordingly ordered the calculation of one integrated APR for both products. This decision has not been observed in the making of the administrative rules concerning APR disclosure in Germany, although it has been repeated on several occasions.

A campaign against the sale of such combined mortgages by a German bank in Alsace, France and several law suits where the cases were settled has been made in France.48

In the following we reproduce the summary of our findings on this product.

2. The Product

1. Endowment life insurance credit is based on a combination of no direct repayment of the capital in fixed credit agreements, where repayments are instead directed into a capital building endowment insurance policy, the goal of which is totally or partially to pay off the credit upon maturity of the policy. This is demonstrated in the following graph where the outstanding decreasing balance of a typical instalment credit (in green) is compared to the credit linked to endowment insurance which maintains a constant balance until the end of the contract. (in blue)

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48 Le Consommateur d’Alsace du 3 Avril 1996 reports under the title „Commerzbank: Prêts: du rêve à la ruine“ (Credit: from a dream to a ruin) about 140 complaints.
In the following table the total outstanding balance of a combined product (outstanding credit minus amount of savings including accrued interest) is compared to a situation in where the same instalment and the same APR in the credit contract would have been directly paid to the credit.
This makes clear that a consumer loses by not using the highest interest he or she can get for the payment, which are obviously the repayment of the loan instead of savings.

2. This product, which enjoys a significant market share in the mortgage markets of Germany, the UK, Scandinavia and the Netherlands, also used in consumer credit in Germany (and probably other countries) is offered by life insurance companies who undertake this business as a side-line to ordinary endowment life insurance. They rely on a particular exception from APR legislation in Germany and the UK which exempts such business from its scope. But life-insurance companies are not allowed to give unsecured consumer credit why this form is solely extended in the form described below.

3. In apparently increasingly large measure this product is being offered by banks who, through their own life insurance undertakings or through co-operation and commission agreements create a larger presence for themselves in consumer credit business, where complicated arrangements will not be seen in the price of the credit.

3. Structure

1. The coupling of endowment life insurance and fixed rate credit is a legal division where the economic function is pure consumer credit business. It was initially offered in this form in the mortgage market by insurance companies because of the restrictions on insurance companies undertaking banking business. It now also enjoys the support of banks because of its intransparency which permits the quotation of lower interest rates and other advantages for the credit provider and insurer together with *misdirected* tax incentives. Such combination-financing is not relevant to retirement savings in life insurance contracts.

2. Relative to the credit, endowment life insurance has a pure earning function. This is shown in the components making up the premium:

   • Within the administrative costs of the premium the credit provider’s administrative costs of the credit and interest payments are covered and taken together;

   • With the savings element the repayment element of instalment payments are redirected and postponed;

   • With the handling fee the credit acquisition will be discharged with the insurance broker and agent or by the bank itself; and

   • With the declining risk profile of the life insurance full repayment of the outstanding credit is ensured.

3. This structure raises the cost to the customer compared with another credit agreement with the same conditions:
• The diversion of repayment contributions into a savings product results in loss of interest because the contributions made into the endowment life insurance will necessarily attract a lower interest rate because of the market interest margins between customer deposits and customer credits;

• The hidden provision for insurance in the gezill rates has the same effect on the credit as a commission payment, which does not clearly appear in its costs;

• The raised amount of credit outstanding - because of small initial savings - results in a raised risk profile premium.

4. This coupling is somewhat deceptive to consumers over the question of costs, advantages and disadvantages:

• The APR quoted in advertisements for coupled credit agreements can be significantly lower than it actually is - following on the interest margin between the yield on endowment life insurance and the level of credit - without giving the consumer lower costs through this arrangement;

• The suggestion that endowment life insurance offers security and steadiness is deceptive because this form of credit is particularly risky;

• The cost elements of the credit are outside of the scope of legislative enactments;

5. The combination has a considerable number of further disadvantages for consumers who take out credit in this way:

• The consumer has the right, according to Art 8 of Directive 87/102/EEC, to terminate the credit agreement without penalty - however, with coupled endowment life insurance there is a considerable loss to the consumer where the insurance policy’s buy-back value is disproportionately less with regard to the number of payments made. Consequently, there is a hidden cost for premature termination of the credit agreement;

• The lack of certainty about the eventual maturity value leads to a raised level of endowment life insurance, to raised risk premiums, as well as to an irrationally lengthened term;

• The respective terms of credit agreements and endowment life insurance are essentially not synchronised to one another, so that the actual term of the credit agreement stems from the repayment of interest only. In this respect there is something of a predicament in the operation of the interest connection, where the endowment life insurance coupling is complicated for the consumer by the agreement to the previous credit provider in any market based valuation of the policy offered by a third party;

• The combination allows the de facto circumvention of the EU Directive on doorstep selling, when an endowment life insurance policy may lawfully be
concluded on the doorstep, a policy which only has any sense if there will be a consecutive credit agreement - so essentially the credit agreement is also being offered.

4. **Legal appraisal (in Germany)**

1. Falling between endowment life insurance and fixed credit, endowment life insurance credit is dealt with by the German courts as a „linked transaction”.
   
   • „linked transaction” is a legal principle from credit law which addresses the splitting up of a single economic process in several legally distinct contracts arising variously in instalment payment business, through the inclusion of costs arising from authorising the credit in the credit price as well as the evaluation of the APR against a „test of immorality“ in lease financing, all leading to the provider facing a reduced need for compliance with consumer protection regulation.

   • This principle is generally known as that of „anti-avoidance“ and appears in article 14 of Directive 87/102/EEC. In judgements relating to the „test of good morals“ in endowment life insurance in consumer credit, the highest German court, the *Bundesgerichtshof* has a single process of dealing with such arrangements and of identifying the APR.

   • The characteristics which lead to a „linked transaction“ in a legal sense, stem from the same date of termination, the collaboration of both partners (bank, insurance company), the relationship (insurance) with the credit authorisation, the pure earning function of the insurance for the credit towards the exclusive goal of paying off the credit together with the connection of both contracts in their operation, ending and early termination provisions.

2. The finding of economic unity has the legal consequence that consumer protection measures in these area of credit law are to be applied not only to the dependant fixed credit but also to the whole set of interdependent agreements.

   • Concerning the payment protection insurance element within endowment life insurance, it follows from the wording of the consumer credit Directive that costs relating to payment protection insurance are to be included when these are obligatorily to be taken with the credit. The insurance product will certainly be offered in conjunction with the credit and the payment protection insurance cannot be excluded from the endowment life insurance because of insurance regulatory requirements (prohibition of a pure savings contract) - this amounts to the obligatory requirement of the connection. The publication by the *Bund-Länder-Kommission* entitled „Price quotations“ as well as a publication by the Office of Fair Trading in the UK which offers a different view contravenes EU law.

   • According to Article 1(a) of Directive 87/102/EEC credit brokerage fees must be disclosed. The veiling of such a provision within endowment life insurance is a contravention of the law.
• In all, according to Art 4 of Directive 87/102/EEC the APR is to be calculated with regard to payment flows for both the credit and the endowment life insurance.

5. Consequences

1. APR quotations in advertising and marketing contexts must be correctly presented according to Art 3 of Directive 87/102/EEC - so that any misrepresentation arising from a better interest rate than in normal bank credit will be avoided.

2. In as far as a single rating is concerned, the general consumer protection measures also have application.

• The right to give notice of termination under Art 8 of Directive 87/102/EEC proscribes all forms of complicating termination. Thus, credit providers must be careful that the application of the legal rules to the whole set of agreements does not result in a higher APR where the consumer terminates the agreement. This applies to the buy-back value of payments made into the endowment life insurance - which should not result in a higher APR than the originally quoted rate (minus one-off charges).

• Credit providers are required to disclose descriptions of all cost elements, single and repayment, also for endowment life insurance according to Art 4 of Directive 87/102/EEC.

• The Directive on door-to-door selling is applicable to the selling of endowment life insurance at the door, where such policies actually pave the way for the later conclusion of a credit agreement, the pressure to buy having factually already been made.

6. Calculation

1. The APR calculation may be simply undertaken with the help of standard spreadsheet software on the basis of the contractual dates - it is also possible to estimate the surplus contributions through an iterative procedure corresponding to the payment flows.

2. The calculation of the buy-back value on early redemption is possible in the same form as the APR calculation, except that here there must be only an approximation of the interest rate. The same is true for the calculation of any claim for a refund.

Some consumer organisations make use of an appropriate computer programme - provided by IFF - that can calculate the APR with no significant problems if the value of the endowment policy at the time of the expiration is indicated or may be estimated.

D. Credit cards

Credit card usage is doubtless the most significant cross border application of credit. As well as forming a credit agreement, credit cards are also a convenient means of
payment (as with charge cards such as Amex and Diners). Some charge an annual fee and many offer variable rates of APR as marketing devices for example, initial interest rates on transfer balances.

There can be other benefits to being a cardholder such as basic default travel insurance, access to free legal advice, emergency help when abroad and even hire car insurance for USA issued cards.

Credit card APRs depend on the amount borrowed so all lenders must assume a figure, in the UK ordinarily £1,000. “Gold” cards tend to assume a higher figure of £3,000 which makes borrowing appear cheaper than on an ordinary card even with the same charges and interest rate.

If there are no initial or monthly fees, the size of the loan is irrelevant so APRs are comparable. The £120 fee payable for the Co-op Gold Base Rate Visa Card distorts the APR between 19.4% if £1,000 is borrowed down to 8.6% if the amount is £10,000.

This survey has not revealed any specific problem in this area. The general problem is how to identify those fees that are linked to the payment function of a credit card and those that are linked to the credit function. As far as insurance products are concerned, it seems to be straightforward to allocate functions either to the payment or the credit function of the card. But with regard to the present status of the inclusion of PPI premiums into credit cost, credit card companies can use this facility to increase their income. As credit card credit is especially vulnerable to unconscious decisions of consumers (they may often think they will be able to cover the amount at the end of the month) which are made in doorstep situations, the argument for regulation concerning the inclusion of PPI here is compelling for a logical credit card market.

In the near future the market will give rise to some card arrangements where credit fees are wrongly allocated to payment functions. This is especially true where credit cards are merely used as a means of access for credit. If, as for example in the USA, a consumer may have up to ten credit cards in order to use credit when the credit of one card is exhausted, it seems to be clear, theoretically, that the charges taken for the bank account and the cards are in fact credit charges. But this will be difficult to prove because a credit card company may not know why a consumer takes out a card. Presently this problem is not so visible in Europe because, perhaps with the exception of the UK, credit cards still have their main field of application in the payment system.

On the continent, most credit cards do not provide independent credit but only give access to the overdraft credit on the consumer’s current account. However, this is changing.

In any event, the real problem of credit cards does not lie in the fees connected with them. These are mostly insignificant if the amount of consumer credit taken out is comparable to instalment credit.
There is another problem which may arise, leading to so-called „secured credit cards“ in the USA. Consumers who no longer have access to ordinary consumer credit because of their poor credit history are offered credit cards where they can borrow their own money for a year or two in order to develop a better credit history. Such cards require that the card holder holds assets of, for example $2000 with the bank which bear interest at a modest rate. Then the consumer gets the opportunity to borrow her own money at a high interest rate. Additional charges and fees arise so that the true APR of such credit can easily amount to more than 60% if it were treated as an endowment credit product where the total balance of both products is compared with the total payments of the consumer.

Regulation bringing combined products made up out of credit, savings and insurance within its scope would easily be able to compel such suppliers to disclose the true and inclusive APR.

E. Bank Account Fees

There is some evidence that the exemption of bank account fees from the APR calculation is being abused by some banks. While most major banks do not charge an extra fee to give credit, to provide a special number and to link the payment function to the current account of the borrower, consumer credit banks may compel consumers that have an account with the bank to open a special credit account for the sole purpose of paying instalments. Particularly in variable rate credit and credit card credit significant charges are imposed on the consumer.

This seems to be a clear circumvention of the Directive’s purpose to include all charges directly connected to the credit. Viewed as a mere separation of the repayment function of credit, the bank currently has the right to „outsource“ such services, charging the consumer outside the credit contract.

The criteria of „reasonable choice“ alone would necessarily bring such attempts outside of the scope of the exemption. But unfortunately this criteria is linked to the problematic usury criterion of „abnormally high“ charges. As the Austrian expert has correctly submitted, such criteria are not practically applicable.

- Firstly, if there is no choice there is also no market for products which cannot be chosen.

- Accordingly, if there is no market there can be no „normal“ market price for such products.

- If there is no normal price then it follows there can be no „abnormally high“ price.

In practice, excluding special account fees from the APR where the consumer has no choice is an invitation to allocate charges to such products. This makes credit arrangements appear cheaper – agreements which in fact offer the highest burden for consumers, namely variable rate credit and credit card credit. The regulator should not give such incentives to the market.
If the second criteria were to be omitted, the Directive’s example would be appropriate to exclude such account fees that have the sole purpose of circumventing the Directive.

F. Taxes, registration fees

In the opinion of the author, taxes and official fees as they exist in Austria and France should be included in the APR because they are part of the payments a consumer has to pay. This situation is comparable to the surplus tax (TVA/Mehrwertsteuer) which also has to be included in price disclosure in all Member States. It would amount to unfair competition if such charges were not made apparent to consumers who want to compare the true burden occurred by products in different countries. This would also help to develop more harmonisation in tax law which, in its present state, significantly affects the comparability of prices for financial services especially in investment, retirement savings and mortgages. But in consumer credit the significance of such costs is quite low and does not merit special action.

G. Colourable Cash Price

Some country reports have highlighted the question of „colourable cash prices“, which particularly occur in the credit offers of motor vehicle companies and their finance houses.

This phenomenon has previously been discussed only with reference to household items where the Directive includes such charges that would not have been made in a cash purchase. As this clause does not specify the requirement of proof in establishing such cases, this issue is problematic because of the nature of such deals for cash payment.

Despite the regulation, the true problem lies particularly in the car market and, in the UK, soft furnishings where large suppliers constantly use close to zero interest credit offers to market products which would otherwise be difficult to sell. They have thus shifted competition from the price of the commodity - for which they want to be seen to be competitive - to the price of an instrument for access to this commodity.

As long as these advantages are only given to buyers who take out the credit, the true advantage lies solely with them so that a low APR represents the true advantage. But this is mostly not the case, particularly in the new car market.

It is submitted that the uniform prices for cars disclosed in advertising are not the true prices charged on the market. All dealers, in spite of frequent cartel pressure exercised upon them not to, do give deductions or offer advantages for cash buyers representing up to 10% of the purchase price.

One manifestation is particularly high trade-in prices for the used car which is taken in exchange for the new car. Sometimes, even cars only suitable for scrap are bought in order to circumvent the pressure of the manufacturers. But most car dealers also offer direct deductions or free extras. Such advantages simply do not arise when consumers finance the car with the car dealer. In this case, the disclosed APR would not be the true APR but would have to be raised by those parts of the cash price
which other buyers would have received in the same situation with paying in cash. In this case taking out credit with another bank and buying with „cash“ would reveal the true APR.

The easiest way of managing such circumventions of Art. 1A of the Directive would be to give consumers the right to a correction of the APR, by deducting those advantages from the net credit - which they can prove other consumers received with cash.

H. Default charges and early repayment

The question as to what fairly amounts to non-compliance may be not be entirely straightforward. Credit providers will factor costs resulting from non-compliance into the general pricing of their agreements, not only in terms of bad debt provision but also in terms of credit control, as must all businesses.

An extreme example of this can be seen in the operation of weekly collected credit providers in the UK - who claim to provide for a few late payments as standard. Accordingly, providers argue that a credit agreement spanning 30 weeks will usually not be discharged until 36 weeks have passed.

Although the Directive is quite clear on excluding cost elements which arise because of default, the APR disclosure is deeply affected by the way transaction costs are allocated either as a risk element in the credit price or through a concentration of such costs on those who default. Here, national regulation capping costs in the case of default - as is the case in Germany and to a lesser degree in France and the Netherlands (but not the UK) - affects the opportunities of lenders to distort their credit price.

For example, in Belgium the default interest rate is limited to the average of the contracted APR and the legal APR. In Germany the law fixes this rate at 5% above the prime (base-lending) rate but in Austria higher rates than the agreed APR are allowed, just as in the UK. Moreover, Belgium accepts that in the case of early repayment only 75% of the outstanding interest must be refunded while in Germany all outstanding interest - but not initial fees – must be refunded.

It is clear that the regulations of default unevenly distribute the possibilities to charge consumers in default with the global costs of default. That is why in default-unregulated countries, the general APR should be higher because such cost and risk elements have to be distributed evenly to all consumers. But instead, in these countries the banks have solved the problem by outsourcing such risks to insurance companies or more correctly to the risky consumers themselves. This increases the burden still more so that the social effect of default regulation is heavily undermined and even reversed.

The problem cannot be solved with APR legislation. The APR can only highlight those costs which are part of an ordinary contract. All other calculations cannot be based on known facts.
In 1978 the author of this report proposed\textsuperscript{49} to disclose a „risk rate“ as a second indicator which would express the cost burdens incurred by a defaulting debtor after half of the lifetime of the credit, presented as an APR relating to the cost of the first six months of default. But information about cost in default situations is not significant to consumer choice because psychologically each consumer believes that she will not default. Instead, the present way of limiting default charges is the correct way and should be followed. Special provision on the harmonisation of these measures together with measures to harmonise personal bankruptcy are necessary. The APR should in any event not be affected by this directly.

\textsuperscript{49} see Reifner, Alternatives Wirtschaftsrecht am Beispiel der Verbraucherschuldung, Luchterhand:Neuwied 1979 p. 430 §5 alinea 1 No. 5