Priorities of the next European Commission for credit[1]

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Explainer

Introduction

There have been significant developments regarding the credit market since the last time Europeans voted in elections to the European Parliament. The 2024 elections are taking place under very different geopolitical and macroeconomic circumstances than those of five years ago. These circumstances will influence the Commission's policymaking efforts in the next institutional cycle.

Digitalisation has changed the way credit is provided. Many consumers now look for online loans and sign their contracts using digital means. Digitalisation has resulted in the appearance of new products such as buy-now-pay later (BNPL) or peer-2-peer lending and the rapid growth of others, like payday loans. New actors have also emerged, for instance FinTechs like peer-to-peer lending platforms and crowdfunding platforms.

Equally, the use of automation for credit scoring is becoming widespread and with it new technologies such as AI and machine learning are growing in importance. Consequently, data-sharing has become a core element of efficient credit markets. While creditworthiness assessments used to be performed mostly on the basis of credit history, nowadays multiple other sources can support credit providers' assessments.

High inflation and geopolitical challenges have resulted in a very volatile credit landscape. We are likely going into an institutional cycle with 'high' interest rates, which contrast with the record low interest rates of the decade prior to 2022. This increases the cost of credit and particularly impacts variable rate mortgages.

These developments bring forward significant challenges for legislators. New players and new actors need to be regulated to guarantee a level playing field, prevent unfair lending practices and guarantee consumer protection. The increased use of data might result in more efficient creditworthiness assessments but it also poses questions regarding data protection and privacy concerns. For instance, there are concerns about the use of dubious data for credit scoring such as data taken from social media. Legislators also need to consider developments in other areas. The more comprehensive the

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data is, the more added value it might have. This highlights the need to follow a cross sectoral approach to data sharing as specified in the European data strategy. This can only be achieved by guaranteeing interoperability between the different data sharing spaces.

Equally, high interest rates, more volatility and the subsequent increase in credit costs might result in a rise of overindebted consumers. Those more vulnerable are particularly at risk. Legislators also need to take into account sustainability. Currently green loans constitute a small share of the total amount of credit, yet they need to be promoted to achieve the EU's sustainability goals, especially green mortgages.

The European Commission's efforts in the credit landscape in the previous legislature already focused on addressing some of the above challenges. With the review of the Consumer Credit Directive (CCD2), new products such as BNPL as well as credit for under EUR 200, which normally carry more risk, entered into scope guaranteeing that they had appropriate consumer protection. The focus was also on how to improve creditworthiness assessments. The recently published AI Act will apply to how AI is used in providing credit. Meanwhile, the proposed Financial Data Access Regulation (FIDA) addresses access to data and data sharing in the transition from Open Banking to Open Finance.

After an intense policymaking institutional period, legislators' work in the next five years should continue to focus on properly addressing these persisting issues. CCD2 and the AI Act will both enter their implementation phase. Adequately transposing them will be the focus over the next few years. FIDA still needs to be negotiated and agreed.

Market players require more clarity as well as more time to implement all the recently adopted legislation. Many of the recent proposals interact with each other, creating market confusion. Regarding data usage, CCD2, the AI Act, the GDPR and the upcoming FIDA will apply, sometimes contradicting each other. Further harmonisation should be prioritised so that they actually complement each other. Clear guidelines are needed on how they are supposed to interact with each other.

The biggest policy proposal planned in the credit area for the next five years is the review of the Mortgage Credit Directive. Like CCD2 it should be updated to adjust to new market developments resulting from new technological developments, the appearance of new actors and new products and an unstable inflation outlook that could have very dire consequences, especially for those with variable rate mortgages.

Other proposals linked to credit markets in the next legislature are expected. Several debates are already ongoing, such as regulating personal insolvency or the further harmonising of creditworthiness assessments.

This ECRI Explainer explores the policy initiatives that will be the main focus of European legislation in the 2024-29 institutional cycle.

Pending level 1 file: adoption

Financial Data Access Regulation (FIDA)

The financial sector is continuously becoming more digital and data-based, becoming a central part of the EU's internal market. The development of a data-driven credit sector has allowed for the creation of a more efficient and safer EU credit market. More data collection has allowed financial players to better understand consumer profiles, allowing them to offer much more tailored credit solutions. With this proposal, the Commission is proposing a new backbone for European financial markets, moving away from open banking and closer to open finance.

Nevertheless, the increase in data volumes requires market players to have the capacity to properly manage and store data to ensure security. On top of this, they will have to develop expertise on analysing the data and they will need to improve their efficiency in terms of processes. They will also need to respect consumer rights and data protection rules. To facilitate this, a possible solution is to develop clear legislative rules that protect data holders, credit institutions, SMEs and consumers.

The proposed regulation aims to define who can access data and how data can be accessed by different players. It also highlights the importance of safeguards by making each party responsible for the activities they perform. It establishes a compensation scheme and increases the control that SMEs and consumers have on the data related to them. All these aspects have a direct impact on the credit market. Nevertheless, there are certain aspects of the FIDA proposal that require further consideration.

When a request for data access is sent, it is essential that the recipient is clearly identified, to ensure the enquiry comes from a licensed entity. While certain structures are already in place through other regulations**, FIDA must clarify which safeguarding mechanisms are available and how they ensure a high level of consumer protection.**

FIDA should also differentiate how personal and aggregated data are treated. For financially relevant personal and company data, consumers and SMEs should have the possibility to review how their data is shared. The power handed to the consumer should though be more limited when aggregated data is shared.

To ensure a level playing field, a reciprocity requirement is necessary. Otherwise certain third parties active in the credit field could – because of their market position – gain an unfair competitive advantage.

Equally, **the data used should be, under all circumstances, limited to financially relevant data**. For maintaining a well-functioning credit market, creditors' use of financially irrelevant data should never be allowed, irrespective of whether they hold such data. It would create a disproportionate advantage, but most importantly, it would be harmful to the consumer.

Third-party actors from outside of the EU, who could gain access to the credit data available under FIDA, must be very carefully monitored. Any player getting access to data should be scrutinised under the same standards as those that are based in the EU. Otherwise the consequences would be twofold. First, an unfair advantage could be gained. Second, consumer data could become available to third parties that should not have access, as it would not be possible to monitor how the data is used and safeguarded. It could lead to sensitive data leaks, putting the consumer at risk of fraud.

Nevertheless, the safeguarding measures should not be overly protective of the data holder. **A mechanism must also be in place allowing third parties to access the data in a meaningful way, ensuring a level playing field.** The data holder should not be able to deny data access without justifying why to any market actor, regardless of whether they are established players, big-techs or new market participants, such as Financial Information Service Providers. If the access was denied for unjustified causes, a compensation mechanism should be guaranteed. Denying access to financial data could push players out of the European market, which move would be detrimental to competition. That is why European Supervisory Authorities should support governance activities to ensure data providers behave properly but also to guarantee that data users manage information properly.

There is also confusion over whether FIDA would apply to creditworthiness assessments. Paragraphs 9 and 19 exclude creditworthiness assessments, while Article 2 includes a direct reference to firms' creditworthiness assessments as 'a part of a loans assessment' being in the regulation's scope. It is therefore essential that this is clarified during future negotiations.

For all firms performing a creditworthiness assessment, accurate and objective data are essential. **Data holders must be informed about the data that can be held and considered relevant for a creditworthiness assessment.** Currently, what is defined as 'relevant data' is vaguely formulated and based on a very broad definition. It would therefore be necessary to develop a clear description of which data is financially relevant within the scope of a creditworthiness assessment. A way to facilitate this would be to ensure that the FIDA Regulation is aligned with the CCD2. A reference to the Consumer Credit Directive would also remove potential confusion over any other issues when further discussing the proposal.

A final point to be considered is the added costs related to developing and implementing data sharing infrastructure, allowing for the safe management and transfer between stakeholders. Here, changes have been made under FIDA when comparing with PSD2. FIDA proposes to allow data holders to include a fee when granting access to data. The division of costs between different players allows data holders to innovate and continuously improve their structures, and to reduce their development and maintenance costs .

The cost endured by a data holder goes beyond the technical infrastructure that allows for data sharing. Collecting and structuring data is also costly**. It could therefore be beneficial to set up a broader burden-sharing structure and for the compensation model to be aligned with the EU Data Act.** This would allow compensation to include a certain compensation margin that would support systems modernisation.

Level 2 files: implementation

AI Act

Credit scoring systems are increasingly being automated with the aim of developing more efficient and accurate creditworthiness assessments. One of the main benefits of these models is their ability to analyse more data sources than traditional scoring methods, which were normally only based on credit history. With automation, payment data, transactions data or even employment history can be taken into account. Evidence indicates that the use of more comprehensive data tends to correlate with more inclusive, efficient and stable credit markets. AI, and in particular machine learning, offer new opportunities to improve the accuracy of risk models, surpassing traditional models in terms of predictive power. It also allows more consumers to access credit which can be a challenge for those without a credit history. These outcomes are positive, as they will result in fewer consumers taking out loans that they cannot pay back. They also contribute to the financial sector's sustainability and resilience and are ultimately good for society as a whole.

At the same time, the use of AI-based credit scoring entails risks that need to be addressed and properly managed. This technology could result in unfair bias and discrimination. There are also concerns about the misuse of personal data and about the safeguarding of data. If not managed these risks may undermine the accuracy and fairness of AI models and negatively impact consumers.

To cater for these challenges, EU regulators have categorised credit scoring as high risk under the AI Act. This has the potential to impact AI's adoption in credit markets as it means that to use AI systems for providing credit, it would be necessary to comply with a series of additional requirements that refer to data quality and governance, documentation and traceability, the provision of information and transparency, human oversight and robustness, and cybersecurity and the accuracy of the AI model. These models will need to be tested before being put in place to ensure that they comply with all requirements. Nonetheless, for those falling under the Capital Requirements Directive some of these requisites will have been fulfilled.

The next step is implementation. The European Commission's AI office will have to develop standards and requisites for evaluating AI models. National authorities also have to be designated in each Member State to supervise – as well as to deploy – regulatory sandboxes. Supervisory expectations should be harmonised across the EU and across sectors (which might be subject to different supervisors). **Guidelines and second level regulation issued by the Commission and the AI Office would be very positive for specifying the general requirements set out in the regulation and ensuring that all industries are subject to the exact same requirements.**

The AI Act has created some confusion for credit markets actors, which should be resolved as part of those next steps**. It is not clear what falls under its scope – whether it is the entire credit scoring process, every component that contributes to automation or only the AI model itself.** There have been complaints about the AI definition being very broad which means the included techniques could be interpreted in many different ways. Industry is also arguing that traditional credit scoring statistical techniques which use a predefined algorithm lack the dynamic learning capabilities associated with AI and thus should not be labelled as such if used in isolation.

Another area of contention is the interaction between the AI Act and other legislation. The existing regulatory framework already tackles many of the risks related to the use of AI, both with horizontal frameworks (e.g. regarding data protection or cyber security) and with sectorial regulations (e.g. in the financial sector, existing frameworks on operational resilience, third-party risk management, loan origination, markets well-functioning etc.)

The proposed FIDA Regulation will significantly increase the data available from financial institutions but questions remain over how that data can be used for creditworthiness assessments and also ultimately for AI-based credit scoring. Consumer protection rules are also very important, in particular the GDPR. A recent European Court of Justice ruling, on the German credit reference agency Schufa, considered that their automated credit scoring falls into the GDPR category of profiling. The decision will most likely result in significant changes in the use of automated processes for providing credit in the EU. This highlights the importance of having very clear rules on AI.

Now that the rules are about to be put in place, it is time for implementation, which will need to guarantee that companies are able to comply in an effective and efficient way. For the financial sector, this should include ensuring the smooth integration of new AI rules into the existing supervisory framework. **It is fundamental that the AI Act and other related rules are implemented in a way that does not hamper innovation and allows companies to reap the benefits that AI can bring to the credit sphere.**

After all, more accurate creditworthiness assessments are not only a way for financial institutions to avoid risk but also to have clear positive benefits for society and for the consumer. This is why regulators and the industry need to work closely together to set the right framework in place and to ensure appropriate implementation.

Consumer Credit Directive 2 (CCD2)

The first Consumer Credit Directive (CCD) was set up to create a single credit market, allowing for a level playing field. Introduced in 2008, it clarified consumers' rights, the creditworthiness assessment process and it standardised how credit conditions are presented to consumers. Since its introduction, credit markets have become increasingly digital. This has allowed consumers to access credit and allowed the development of entirely new credit products. More than a decade later, in 2021, the Commission proposed a new Consumer Credit Directive, with implementation starting at the end of 2023.

The Commission, as part of its Consumer Finance Action Plan, set the objective of facilitating cross-border consumer credit. The new Consumer Credit Directive aligns with this plan by supporting the further standardisation of creditworthiness assessments and to further harmonise credit markets. **As the Commission opted for a directive rather than a regulation, supervising how national authorities implement the directive is crucial.** There is a risk that implementing authorities adopt the lowest standards or 'gold plate measures' to support national players. Consumers will carry the largest share of the burden if implementation across Member States is not harmonious. If that happens, it would jeopardise the level playing field at European level and the ambition for a more integrated single market.

The directive also strives to simplify and better clarify the precontractual information provided to debtors and sets a level playing field by mandating that creditors and credit intermediaries are subject at national level to an adequate admission process, to registration and to supervision arrangements set up by an independent competent authority.

Crowdfunding credit, which is increasingly popular, was excluded from the directive for later review which will take place in 2025. **As with any new product, the review should prioritise consumer protection. Not doing so would expose them to unnecessary risks.**

Level 3 files: future

Mortgage Credit Directive (MCD)

The Mortgage Credit Directive will be reviewed by the next Commission. The directive was published in 2014, although implementing it only concluded in 2019. It is thus a relatively new directive which intuitively points to the need for only small changes. Nonetheless, significant market and policy developments in the last few years are likely to mean that the directive will require an update.

Digitalisation is changing the way mortgage credit is provided. The new legislation on mortgage credit will have to address the emergence of new actors such as non-bank lenders, peer-to-peer lenders and crowdfunding and new products like reverse mortgages. Equally, consumers are now increasingly accessing mortgages through digital means, which should also result in specific changes to the directive to allow for the end-to-end digitalisation of mortgage loans. The requirements for advertising materials and the mandatory content of pre-contractual information were designed in the MCD to be presented in a non-digital format. Today, most people now view them on a screen. Consequently, they should be adapted with a focus on condensing the most relevant information for the consumer.

The use of new technologies, particularly AI for creditworthiness assessments and robo-advice also needs to be addressed. As already explained, these developments present a great opportunity but they also come with significant challenges, particularly regarding consumer protection. Ensuring coherence with other relevant legislation such as the AI Act, the GDPR and FIDA is vital.

The review comes at a moment of high market volatility with a growing prevalence of variable rate mortgages in some Member States. Persistent high inflation can significantly increase the costs of those on variable rate mortgages, which naturally leads to the increased risk of over-indebtedness and of non-performing loans.

Consumer protection requirements will have to be enhanced, also taking into account that given the length of mortgages, clients are more vulnerable to unexpected events than with shorter loans. More options are likely to be given to vulnerable consumers in the form of debt advice in line with the CCD2 obligation for Member States to provide these services.

Another element that needs to be explored is personal insolvency. **At this moment, there is no legislation at European level and Member States laws often result in lengthy procedures with high costs which constitute an entry barrier for many people.** The Commission's Financial Services User Group recently called for harmonised EU personal insolvency rules.

A similar debate exists on harmonising creditworthiness requirements across Europe. Arguments in favour point that to increase cross-border loans, one of the Commission's objectives, the data collected to assess creditworthiness should be similar across Member States. On the other hand, there are doubts about whether more cross-border loans are really needed. Such a measure would also restrict lenders' flexibility to grant loans. The big differences in the mortgage markets and differing practices across Member States indicate that such a change could produce a big upheaval and thus requires careful assessment.

Sustainability is also a concern, with buildings being responsible for 40 % of the EU's total energy consumption and 36 % of its greenhouse gas emissions. **The uptake of green mortgages should be promoted in the MCD.** It should include a solid definition of what a 'green mortgage' is. The European Banking Authority also recommends that the European Standardised Information Sheet (ESIS) for mortgages should include information on a building's energy performance and that staff be required to have a good knowledge of green mortgages and what they are.

Foreign currency loans are also a recurring issue. The current definition has been deemed too complex and has created multiple problems. Many creditors have simply stopped offering these kinds of loans and several stakeholders are calling for limiting the scope of the definition. Nonetheless, **previous experiences with foreign currency credits have been very detrimental for consumers and any advance here has to be done with caution.**

Finally, given CCD2's recent adoption, coherence in the general principles needs to be ensured between both pieces of legislation.

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