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MEMO

To : Directie
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From : Knowledge Base NBF1

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CONSUMER FINANCE

Introduction

This memo provides guidelines to evaluate a responsible consumer finance provider. Both basic guidelines for evaluation and analysis as well practical guidelines for due diligence are outlined in the memo below. Access to finance for a consumer is a basic right. Consumer finance is part of the financial system of a society. If and when consumer finance is provided through sustainable and responsible providers, with acceptable credit conditions, it becomes an essential monetary bridge between the productive sectors of a society and its ultimate consumers. Consumer finance takes place via many different delivery channels: 1) specialized consumer finance companies (via phone, direct mail etc), 2) retail stores, 3) pay-roll lenders, 4) vendor credit, 5) family & friends, 6) banks and lastly 7) the loan shark. Although channels differ, the basic consumer finance guidelines apply to all providers. Consumer finance has many characteristics that are similar to microfinance organisations. In fact the distinction between microfinance and consumer finance is rather a thin line as both serve low-income households and micro-entrepreneurs.

Development Impact

Consumer finance is in many emerging market an underdeveloped part of the financial sector, both in number of providers as well as in sophistication. In many emerging markets commercial banks and other financial institutions do not focus on building channels or providing consumer finance to lower income groups. Consumer finance is primarily used by consumers for direct access to consumer durable goods and services (i.e. healthcare and education) under medium term payment conditions. Put in a broader context, such consumer credit delivery systems give lower income segments access to finance to purchase basic goods and services, that raises the quality of their life, lead to efficiency (i.e. from coal stoves to electric/gas-fired stoves), higher productivity and thus to higher income growth. In addition most of these consumer durables reduce the work and burdens of women: access to credit has therefore also an important impact on gender and the life of women. For most customers consumer credit is their first experience and first access to the financial system. Customers build up a credit history, start saving and start using the financial system. Consumer finance stimulates the penetration of financial services in society and a well-developed consumer finance delivery system leads to a better over-all financial structure (banks and non-banks), better competition and more access to credit for all income groups and, last but not least, at better credit terms.

Guidelines

Consumer finance should be executed in an ethical and responsible manner, which ensures consumer protection, provides transparency and discloses relevant information to the consumer. Abusive consumer lending practices, like usurious interest rates, overburdening and intimidation at collection should be avoided. Below you will find guidelines to evaluate a responsible consumer finance provider. We have used the EU guidelines (which are in proposal phase) as well as the best business practices from FMO's portfolio of consumer finance providers.

FMO Basic guidelines:

1) Disclosure of information:

In advertising, pre-contractual information and credit agreements the consumer finance provider should disclose basic information related to the credit: interest rate or annual percentage rate of charge (APR), total amount of credit, duration of credit, number size and frequency of instalments, fees, total costs of the credit, overdue charge, conditions for prepayment. Although in advertising you will not find all the basic information requirements, these requirements need to be covered in the credit agreement between the provider and the consumer.

2) Right of withdrawal/early repayment

The consumer finance provider should provide a right of withdrawal. Although EU guidelines grants a 14 days right of withdrawal without paying a penalty, this seems quite long for emerging markets. At least a certain period should be stated in the contract. The consumer should have the option to repay early against a fair and objective indemnity for the provider of consumer finance.

3) Affordability check/avoidance of over-indebtedness

The consumer finance provider needs to assess prior to extending the loan whether the consumer has sufficient and sustainable repayment capacity. Although no general rule for affordability exists, the provider should have debt servicing limit(s) in place. One criteria of affordability often used is the instalment (interest plus repayment amount plus fees) divided by disposable income. Disposable income is measured as net disposable income after fixed charges such as rent, standard living expenses (water, electricity, etc) and other recurring financial expenses (school fees, mortgages, other instalments etc). This instalment is preferably to be below 30% but should not be above 50% of disposable income.

Avoidance of over-indebtedness is safeguarded by two means: 1) taking into account the repayment obligations of the consumer to other providers into the calculation of disposable income and the maximum limit, 2) by checking credit history at credit bureaus. Check if provider has these mechanisms in place.

4) Responsible Credit collection

The consumer finance provider should follow responsible collection policies, i.e:

- communicate with the consumer directly at normal hours (not before 8 am in the morning or after 9 pm) at the borrower's premises;
- not communicate with third parties with regards to the debt except with permission of the consumer;
- do not harass, oppress or abuse any person in the collection of the debt including prohibition of publication of a list of consumers allegedly in default (no name and shame policy);
- not make any false or misleading representations;
- validate the debt by a written notice sent to the consumer stating the amount, name of creditor and response period (usually 30 days).

Additional guidelines for best practices:

1) Non-discrimination and Equal opportunity lending

Consumer finance provider may not restrict or deny a loan or discriminate in the credit terms based on age, race, colour, religion or sex, handicap, family status or origin. In general a consumer finance provider will take into account the above-mentioned characteristics to determine the creditworthiness of a client however a provider should not have stated or implicit policies excluding certain groups.

2) Refrain from unfair contract terms

Examples could be forced cross-selling or change the rules on the interest rate, etc

3) Treatment of non-performing credit agreements;

Responsible providers will have transparent and modest application of late payment fees, arrears interest and/or penalty fees. Charges may not exceed legal limits (if applicable) or at least should not exceed the 'in duplum' rule, which states that the total claim against the consumer cannot exceed twice the remaining outstanding balance in case of default.

Practical due diligence guidelines:

In order to assess if a provider of consumer finance adheres to FMO's consumer finance guidelines and best practices the following documents and sources of information are to be reviewed:

- 1) advertising materials;
- 2) annual percentage rate of charge (APR);
- 3) example(s) of a credit agreement between provider and consumer;
- 4) credit manual of provider;
- 5) collection manual provider;
- 6) review software (which variables are used for credit scoring);
- 7) any law or regulation on consumer finance (if available);
- 8) a consumer protection agency (if available);
- 9) credit bureau
- 10) bad debt history (check 3 credit files).

Conclusion

Consumer finance is usually the first entry for the low-income consumer into the formal financial services sector and leads to productivity gains as well as improvements to the quality of life of mainly low-income consumers. FMO needs to verify if providers of consumer finance comply with the 4 basic guidelines: 1) Disclosure of information, 2) Right of withdrawal/early repayment, 3) Affordability check/avoidance of over-indebtedness and 4) Responsible credit collection.