An Analysis of the Local Retail Credit Environment

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Abstract

It is believed that consumer debt in Malta has risen to an unacceptable level. This is negatively effecting not only the local consumers but also the business community.

This paper reviews the background to the local retail credit environment. It makes reference to the competition; local banks; management philosophy of the local traders, and the economic factors which have contributed to the present credit scenario and to the attitudes towards consumer credit in general.

This paper explains the risks and cost involved in credit and investigates the traders' motives to grant credit to consumers. It claims that the rational behind granting credit are merely Sales and Marketing, External Pressure and Investment.

It continues to report the implications and consequences of over-indebtedness in Malta and elicits some common experiences of the local traders pertaining to defaults in credit agreements and payments.

This paper concludes by giving due considerations and recommendations, which comprise mainly education and data sharing.

1.0 Introduction

From a historical perspective, consumers' attitudes to debt have changed dramatically in Malta over the recent years. For many generations, buying something now and pay for it later, was considered taboo by the majority of our ancestors. But the use of credit among the general Maltese population expanded during late 80's and early 90's. Today, it is difficult to imagine not having those consumer goods we want now but could only have them in couple of years' time when we had saved up enough money to buy them.

However, Malta of this day and age is very much characterised by retail credit and its availability. Nowadays, it is commonly believed that, as a society, we are biting off more than we can chew, we are living beyond our means and some belt-tightening is required.

This scenario is causing a slowing down of payments by customers in the local business environment, a significant number of dishonoured cheques being drawn, and a number of bankruptcies in all sectors of our economy.

Despite the fact that this commercial scenario triggered the business community to invest more efforts in the credit management function, late payment is still one of the major difficulties for many local firms. Firms across all sectors of the economy claim that they are facing liquidity problems due to late payments.

2.0 Background to the local retail credit environment

Every country has its own characteristics which effect its economy and the way consumers react and behave in a market. The Maltese retail credit environment is by no means an exception. Harsh competition; local banks; management philosophy of the local traders, and economic factors have all contributed to change the Maltese mentality and their behaviour pertaining to retail credit.

2.1 Competition

Owing to the small size of the Maltese economy, all sectors are highly competitive and fragmented. The retail business environment is characterised by a large number of retailers, trying to push their products and services to maintain their market share or to win new business.

Products and services provided by various retailers can be described as homogenous with low or no differentiation features. A window shopping exercise in one of our high streets, or a walk round our welcoming shopping arcades, would demonstrate that as far as brand, functionality, after sales service and price are concerned, there is little difference from one retailer to another. Very often, the selling crux lies in credit terms, the interest-free credit on offer, and the once in a life-time buy ‘now’ and pay later offers, promoted prominently on the outlets’ windows.

The ease to obtain credit is attracting consumers to walk into the shops, as sales can be made to customers who could not afford to pay in full now. Moreover, another benefit to the trader, when granting credit, is the opportunity to sell complimentary items or to cross sell to the customer. Thus increasing the turnover.

2.2 The Local Banks

The local banking industry is characterised by two major banks which have strong influence on our economy and commerce. Banks are in real fact, effecting the local consumers’ perception and attitude towards retail credit. Substantial budgets are being allocated by the banks to promote personal bank loans. They are promoting various types of personal loans, ranging from credit card facilities to loan financing of houses, education, cars, yachts and even for holidays.

Banks are competing aggressively, using effective promotional tactics in order to encourage individuals to borrow for their needs and leisure. Being sales-driven and target-oriented organisations, banks are trying to match credit terms and interest rates offered by their rivals to win more customers. And this is not helping much the way we perceive consumer credit, let alone responsible credit in today’s world.

The following adverts and promotional clichés, used for personal lending and targeted for individuals, are currently found in the market:

"We have come up with great offers on some of our products. By applying for any of these products before 17 February 2007, you can benefit from these great offers:

> Flexicredit Loan
3 month repayment holiday, 1% interest discount, no processing fees and a 6 year term for loans of over Lm5000

> Home Loans and **Maxicredit Loan**
3 month repayment holiday and no processing fees. If you take out a Home Loan during January 2007 you may benefit from a specially reduced interest rate on a Flexicredit loan up to Lm5,000.

> Classic Credit Cards
Fee free for 1st year, 0% interest for 6 months

> Gold Accounts
Fee free supplementary card for 1st year

> Classic Credit Cards
"Shopping & travel made easy"

> Personal Loan
"We can make it happen"
no security is required; customised repayment programme up to a maximum of five years; three-month break in repayments; one-time processing fees.

> Car Loan Facility
"Wheeling around on solid ground"
Payments may be spread over 11 months; no penalty for early loan repayment; free of charge credit cards.

> Personal Loan
"Adding Value to Life"
Optional Moratorium on repayments for the first three months; low cost processing fees; free of charge credit cards.

> Home Loan
"Turning dreams into residences"
No bank processing fees; no bank legal fees; no early repayment fees.

2.3 Management Philosophy

Being small to medium organisations, local retailers are mostly managed and directed by their owners who have great influence on the internal culture and management styles of their firms.

In order to balance the relatively small economic sectoral revenue against the high overhead costs associated with the economic expansion of the 90's, business owners were constrained to enter various sectors of the economy, sometimes completely unrelated to their core business. This had a negative effect on the local credit environment as companies became more sales-oriented and used credit as a competing selling tool to increase sales, sometimes irrespective of the risk associated with credit.

2.4 Economic Factors

In theory, the impact of credit on the economy is positive, only if credit is granted in a responsible manner. Consumer credit makes useful contribution to the living standards and the wellbeing of a society.

The economic expansion of the early 90's, due to liberalised markets and high government spending, has led to high inflation and low unemployment, which has created also a 'feel-good' factor in our economy. These economic factors have transformed consumer borrowing into an acceptable and necessary part of many consumer's lives and generally, have indeed improved our standard of living.

The very low interest rates, during the recent economic slow-down, have had also its effect on consumer credit. Low interest rates encouraged consumers to borrow more. However, interest rates are again rising and this would mean that the credit environment in general can only become worse.

"recent imaginative refinancing packages are adding to the strain"…."debt write offs to increase"

Financial Times, December 2006.

Nonetheless, the rising house prices have also contributed to more demand for personal loans. We live in a society where we want to own the property we live in, rather than renting it. This has led to an increase in loan terms, opened up more credit facilities and loans for longer period of time.

3.0 Retail Credit - Cost and Risk

Following an overview of the local consumer credit environment, it makes sense to understand credit from the traders' point of view.

Credit costs money. Traders should take into account both the explicit cost involved in credit, and also the opportunity cost, those costs associated to the return foregone on additional receivables. Somehow, somebody must finance credit. Therefore, traders have to either finance credit out of their own pockets or borrow money from the banks to finance it, making consumer credit more expensive to the creditor.

Moreover, there is always an element of risk when granting credit, that of being paid late or not paid at all. If this risk is not well calculated, it will effect the cash flow and the profitability of the business.

A report issued by the Directorate-General for Enterprise of the European Commission on late payment, suggests that late payment is hindering growth amongst smaller firms and is causing financial distress to small firms, because smaller firms are in a low bargaining position to enforce credit terms on their customers.

Nevertheless, despite its micro- and macroeconomic significance, credit has been neglected as a management topic for study and research. This is evidenced by the lack of attention given to credit management in the finance text books as well as the shortage of empirical research in the credit management area of study.

To counteract this deficiency, in many developed countries, credit management associations and institutes have been established by the people working in this field. This has also happened in Malta in 2001, when the Malta Association of Credit Management (MACM) was established.

In Europe, fifteen national associations, including MACM, joined forces and established FECMA[1], with its primary aims being:

- *To promote the development of the profession of the credit manager;*

- *To encourage and promote research, study, knowledge, and publication of that knowledge, relating to all aspects of credit management;*

- *To encourage the highest possible ethical standards in credit management personnel.*

Source: www.fecma.eu

[1]Federation of European Credit Management Associations (FECMA) was founded in 1986, and currently consists of fourteen national credit management associations:

Austrian Association of Credit Management - Austria
Instituut voor Kredietmanagement – Belgium
Dansk Kredit Forum – Denmark
Luottomiehet Kreditmannen ry – Finland
Association Francaise des Credit Managers et Conseils - France
Verein Credit Management e.V – Germany
Irish Institute of Credit Management – Ireland
Israeli Institute of Credit Management – Israel
Associazione Credit Managers Italia – Italy
Malta Association of Credit Management – Malta
Nederlandse Vereniging voor Credit Management – Netherlands
Norsk Kredittforum – Norway
Asociacion de Gerentes de Credito – Spain
Svenska Kreditföreningen - Sweeden
Institute of Credit Management - UK

4.0 Motives to grant credit to consumers

The specified risks and costs associated with consumer credit lead us to a logical question:

"What are the motives for granting credit to consumers?"

From a research conducted among MACM Members, who are directly involved in consumer credit, it transpired that creditors grant and extend credit to their customers for three main reasons:

4.1 Sales & Marketing

The primary motive to extend credit is to maintain market share and increase business. Retail credit supports sales and it is used as a tool to gain competitive advantage. Local traders negotiate favourable credit terms with their customers to secure new sales, thus maintaining high sales volumes.

Retail credit is granted and extended in order to hinder sales of the competitors' brands through a means of crowding out the competitors.

Making reference to the IT sector, credit is being used effectively as a strong advertising tool when dealing with both business and consumer clients. IT Solutions providers are offering easy payment schemes and interest free loans over a period of 18 months to their clients when purchasing hardware and software packages.

4.2 External Pressure

Traders affirmed that one of the major motives to grant and extend credit is due to external pressure coming from the competition and the consumers themselves.

Sellers are competing on credit terms to attract more sales and are trying to satisfy the demand for credit coming from their customers. A trader, who was interviewed for the purpose of this paper, contended that

> *"…If your competitors are granting credit, you have to grant similar or better credit terms yourself or else you are out of competition."*

Pressure to grant and extend credit is also being exerted on the sellers from the customers in order to get better deals pertaining to prices and credit terms.

4.3 Investment

This research showed that a key factor to succeed in the local competitive market is to build and maintain loyalty and long-term business relationship with consumers.

Traders interviewed argued that granting and extending credit to consumers, helps to build and maintain a loyal customer-base and keep out competitors from taking their market share. They added that credit is therefore deemed to be an effective strategy to maintain long-term business relationship with the consumers. Another IT supplier argued that

> *"Credit helps to maintain sound long-term relationship with the client. Our business concept is that the client and the IT Service provider enter into a long-term partnership agreement."*

5.0 The problem of over-indebtedness and its consequences

Customers may not be aware of the risks in taking on too much debt, and lenders, who promise low-interest credit deals, are encouraging customers to borrow more than they can afford.

Over-indebtedness leads to defaults in payment, bankruptcies and in some cases, usury. There is no scientific evidence or empirical research identifying any particular segment of the Maltese population who is borrowing more than it is afforded. And in reality, it is not easy to segment the local consumer market in order to establish trends, which would shed light to this problem. In fact, businesses experience defaults in payments from individuals coming from all walks of life with different backgrounds and lifestyles.

Nevertheless, some common experiences shared by the local business community include:

a. Some individuals may be willing to pay for goods and services which are associated with the status of owning them and then will not be able to make good for essential needs and commodities.
b. Some individuals may prefer to play lotto, and consequentially, will not be able to meet their day-to-day expenses. This is more evident when the jackpot prize of the weekly lottery rises to high amounts.
c. Social factors may effect the wellbeing of individuals. The increase in the number of single parents and separated couples are intensifying the late payment problem.
d. The younger generation tends to be more risky and may purchase expensive goods on credit or on hire purchase agreements, for which repayments will not be met.
e. People with lower level of education and on low income, although not necessarily, may lack the required skills to plan and manage their finances and due to peer pressure, wanting to improve their lifestyles, may prompt them to borrow money they cannot afford.

Over-indebtedness problems and consequences cannot be defeated merely by legislation, but by educating both the individuals, as well as the creditors.

Financial planning requires certain literacy and numeric skills, and education in this regard is definitely needed in Malta. Due to lack of adequate education, individuals may however, experience problems with the following:

i. Find it difficult to prioritise as to what products and services are necessary for their day-to-day living;
ii. What financial products best meet their financial needs. Credit card facilities and personal loans are not always the best solution. Sometimes reviewing the current finances of the individual would make more sense;
iii. Keep back from seeking help from an authorised independent financial advisor.
iv. Fall victims to abusive practices from suppliers, including financial services organisations and their agents.
v. Find it difficult to identify welfare benefits they may be entitled to.

6.0 Recommendations

Malta needs to build consumers who can manage their credit effectively, consumers who will be able to understand and master their own finances.

Local authorities and professional bodies should join forces to build a generation who will be able to make appropriate decisions about their own finances. A generation, who will seek professional advice whenever it will be needed, who are educated to shop around before taking up credit or a loan facility and who will be able to analyse the implications of every credit on offer.

6.1 Education

The government has an important role to play. The government has the responsibility to educate consumers. It needs to ensure that all consumers have access to information, debt advice and debt management programmes whenever the need arises. It needs to provide generic information on financial management, basic literacy and numeric skills to ensure that consumers are financially literate.

Education is the key to ensure that consumers are able to make informed judgements and take appropriate decisions pertaining to the individuals' financial planning.

6.2 Data Sharing

Besides self-discipline and education, our country needs to consider the introduction of appropriate data sharing practices and encourage more professional credit reference databases.

From my personal experience, as the Director General of the Malta Association of Credit Management, I can confidently argue that having a widespread practice of data sharing, the mounting problem of over-indebtedness among individuals will be reduced and responsible lending practices will increase, as it is not in the interest of any creditor to grant credit or advance a facility to consumers who are not in good financial health.

Although I believe that a balance should be struck between data protection and the need to share data among credit providers, we should stop hiding ourselves behind certain legislation to keep pertinent data close to our chests. This attitude is harming the society, both the consumers, as well as the local traders.

In other countries, including major European countries, data sharing practices are working properly and smoothly, and I cannot understand why they shouldn't in Malta. Recently, the Department of Trade and Industry (DTI) together with the Standard Committee on Reciprocity (SCOR) in the UK opened consultation regarding the lifting on certain barriers on non-consensual credit data sharing, and this was welcomed also by major banks.

Likewise, we should promote data bases, which would serve as tools upon which lending decisions are made. However, proper regulation and legal set-up is needed. The draft paper of the Consumer Credit Directive itself makes reference to the importance of using such credit data bases.

Data sharing should include both positive and negative information. Positive data would include information on borrowers that have honoured their credit terms and have paid on time. It would include also data related to loan exposure in terms of amounts, term of loans, rate of interest charged (if applicable), collaterals, past performance and other pertinent data. Negative data would include late payments, dishonoured cheques drawn, court actions related to payment defaults and other similar defaults pertaining to credit.

The benefits associated with data sharing are twofold:

a. Creditors will have adequate information to analyse the credit worthiness of their prospective debtors and will be able to monitor their current debtors more effectively. Hence improving responsible lending.

b. Individuals who are over-indebted will not be able to obtain further credit. Therefore, the risk of over-indebtedness will be reduced to the benefit of the individuals themselves.

Nevertheless, this needs collaboration between various stakeholders – the government, the banks, the business community, the consumers' and competition division, the data protection commission, credit reference agencies and credit management associations. Proper legislation needs to come into force and all creditors need to be registered and monitored by a competent authority to safeguard individuals, as well as to support and ensure responsible lending.

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