

Hard Cases

Early Repayment of Loans Under EU Law: The *Lexitor* Judgment

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Abstract

Recent changes in EU law provide flexibility and protection to consumers, facilitating early repayment of loans, when the consumer is no longer interested in continuing a credit relationship. From an economic point of view, early repayment of loans should be facilitated, because it allows money that is no longer needed to be put to other desirable uses. Under current EU law, as recently interpreted in the *Lexitor* judgment by the Court of Justice of the European Union, upon early repayment of a loan, consumers can obtain a pro-rated reimbursement of all the up-front and recurring costs of the loan, including origination fees and ancillary service costs. In this brief article, we take a critical look at the current EU approach to this issue, suggesting that, while the legislature made the pragmatic choice in permitting partial reimbursement of up-front costs, this leads to several economic inefficiencies that can ultimately hurt the consumer. Repayment of up-front costs, and of any other sunk cost associated with the creation of the loan, can lead to a suboptimal mix of lending contracts. Some consumers could, in fact, take out a lower interest rate long-term credit, even though they may only need a short-term loan, and this would create a disadvantage for the overall class of consumers. In order to actually protect the economic interest of consumers and carry out the intent of the legislature, we conclude that the up-front costs for non-mandatory ancillary services (such as brokerage fees, etc.) should not be included in the costs that are eligible for reimbursement in the event of early repayment of the loan. By excluding these costs, consumers will not be incentivized to overconsume such services, minimizing the negative externalities imposed on other consumers.

I. Introduction

Under current EU law, consumers have the right to fully or partially repay loans early and are entitled to obtain a pro-rated reimbursement of all the fixed and recurring costs of the loan. As currently applied, this pro-rated reimbursement includes origination fees, brokerage and legal fees, and all other fixed costs that are associated with the creation of the loan (hereinafter, we shall refer to this category of costs as ‘up-front costs’). But the question remains whether allowing for the reimbursement of up-front costs in the event of early loan repayment is

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economically efficient or even intended by the European legislature.

The rules governing early repayment of loans have emerged gradually in the EU over the last several years. The European legislature recently issued Directive 2008/48/EC in an effort create ‘a well-functioning internal market in consumer credit’.¹ As part of its goal to establish a well-functioning market, the European legislature granted protection to consumers who wished to ‘discharge fully or partially their obligations arising from (a) credit agreement before the due date’.² In other words, the Directive granted the consumer the right to repay loans fully or partially at any time. It additionally provided that consumers are ‘entitled to a reduction in the total cost of the credit, such reduction consisting of the interest and the costs for the remaining duration of the contract’.³ The total cost of the credit, as defined in Art 3(g) of the Directive, includes ‘interest, commissions, taxes and any other kind of fees which the consumer is required to pay in connection with the credit agreement’.⁴ The total cost of credit also includes any fees for ancillary services if ‘the conclusion of (that) service contract is compulsory in order to obtain the credit or to obtain it on the terms and conditions marketed’.⁵

In the well-known *Lexitor* case,⁶ the Court of Justice of the European Union (CJEU) interpreted these provisions to mean that consumers have the right to receive a pro-rated reimbursement of both the fixed, up-front costs and the recurring costs⁷ of a loan in the event of early repayment. The decision was met with criticism and reluctance to comply by credit institutions.⁸

The Advocate General in his opinion, and the CJEU in its judgment, asserted that the choice made by the European lawmaker to reimburse both up-front costs and recurring costs was a pragmatic choice rather than an ideal one.⁹

¹ European Parliament and of the Council Directive 2008/48/EC of 23 April 2008, on credit agreements for consumers and repealing Council Directive 87/102/EEC [2008] OJ L 133/66.

² European Parliament and of the Council Directive 2008/48/EC, n 1 above, Art 16(1).

³ European Parliament and of the Council Directive 2008/48/EC, n 1 above, Art 16(1).

⁴ European Parliament and of the Council Directive 2008/48/EC, n 1 above, Art 3(g).

⁵ European Parliament and of the Council Directive 2008/48/EC, n 1 above, Art 3(g).

⁶ Case C-383/18, *Lexitor v Santander Consumer Bank S.A.*, Judgment of 11 September 2019, available at www.eur-lex.europa.eu.

⁷ Recurring costs are the costs incurred by the lender while the loan is in progress. In other words, they are the costs that ‘depend objectively on the duration of the contract’. Case C-383/18 n 6 above, para 24.

⁸ See, eg, Intesa Sanpaolo, ‘Information on risks and relative hedging policies’, available at <https://tinyurl.com/t262ujx6> (last visited 30 June 2021) (stating that it believed the Italian banking law Article 125-*sexies* could not be interpreted in a manner that complies with the *Lexitor* ruling and that while it would comply, it ‘reserves the right to reconsider this operational stance in light of future developments’); Prawo, ‘Polish banks are disregarding the Court of Justice of the European Union judgment regarding loans; Civil Rights Ombudsman set to intervene’, available at <https://tinyurl.com/54nvyz5> (last visited 30 June 2021) (discussing that some Polish banks ‘are proving loath to refund all the costs incurred by them’ despite the CJEU’s decision).

⁹ Case C-383/18, n 6 above, paras 33-34, 55, 63-65, 68. In para 53 of his Opinion, the Advocate General stated that the rule establishing that up-front costs are not reimbursable while

First, there was the practical problem of distinguishing between up-front and recurring costs.¹⁰ Second, there was a risk that if it established that up-front costs were non-reimbursable but recurring costs were reimbursable, credit institutions could use their discretion in invoicing costs to increase up-front costs to artificially lower the amount of reimbursable costs.¹¹ In other words, the credit institution could categorize a recurring cost as an up-front cost and charge the consumer when setting up the loan to avoid any potential reimbursement in case of early repayment. Because of these issues, the Advocate General and the CJEU concluded that the European legislator chose a rule that is easier to apply, under which all the up-front and recurring costs of the credit, as defined by the European Directive, are reimbursable on a pro-rated basis.¹² But as discussed in this article, allowing for the reimbursement of the up-front costs of a loan can create several inefficiencies, hurting both the consumer and the market for credit. While these inefficiencies exist because of the pragmatic choice of the legislature, the inefficiencies of this rule can be limited by making non-mandatory ancillary services — those voluntarily purchased by the consumer — ineligible for reimbursement. This conclusion is supported both by the intent of the legislature as well as by considering the economic incentives.

The remainder of this article is structured as follows. In Section II, we discuss the economic incentives created by the EU rules regarding early repayment of loans, providing special focus on whether granting consumers the right to early repayment is economically efficient and whether mandating partial reimbursement of up-front costs, as interpreted by the CJEU, is economically efficient. In Section III, we consider the question of whether consumers should be entitled to receive a reimbursement of the cost of third-party services that were not required for obtaining the credit, ie, non-mandatory ancillary services, such as the cost of financial advice and intermediation or additional insurance. We analyze both the intent of the European legislature in drafting Directive 2008/48/EC as well as examine the economic incentives under such a rule. In Section IV, we provide concluding thoughts on whether Directive 2008/48/EC and the *Lexitor* judgment should be interpreted to allow partial reimbursement

costs dependent on the duration of the loan are reimbursable may ‘appear (...) at first sight to be relatively simple and therefore interesting, (but) its practical application will probably give rise to considerable difficulties of a practical nature. Indeed, as highlighted by the referring court in its request, credit institutions rarely specify which of the costs they incur are covered by the costs charged to consumers and, even when this occurs, the consumer would be entitled to dispute the accuracy of such specification’. The Advocate General added that maintaining the distinction between up-front costs and costs dependent on the duration of the loan may be impractical because ‘in the event of a dispute over the amount of the reduction to which the consumer is entitled in the event of early repayment, national courts (would) have to call on the services of accounting experts, even if, by their nature, the costs in question are relatively modest’. Op. A.G., Case C-383/18, *Lexitor*, paras 53, 55.

¹⁰ Case C-383/18, n 6 above, paras 33, 53, 55.

¹¹ *ibid* paras 31, 54.

¹² *ibid* paras 37, 66, 68.

of voluntarily purchased services in the event of early repayment. In sum, we conclude that the European legislature did not intend for non-mandatory ancillary services to be partially reimbursable in the event of early repayment, and the economic incentives support this conclusion.

II. The Law and Economics of Early Loan Repayments

The European Directive 2008/48/EC gave consumers the right to repay a loan early and to receive a pro-rated reimbursement of the ‘total cost of the credit’. The *Lexitor* judgment interpreted this to conclude that in the event of early repayment of a loan, the lending credit institution must provide a pro-rated reimbursement of both recurring and up-front costs to the consumer. But allowing for the reimbursement of up-front costs creates several inefficiencies in the market for credit. While this choice may not be the ideal choice, as described by the Advocate General and the CJEU, it was the pragmatic choice.

1. The Pragmatic Choice of the European Legislature in Enacting Directive 2008/48/EC

Under Directive 2008/48/EC, in an aim to provide flexibility and protection to consumers, the European legislature granted consumers a right to early repayment of loans when the consumer is no longer interested in continuing a credit relationship. From an economic point of view, this may be considered efficient by allowing the capital to be put to more desirable uses. But if such a clause were truly efficient, then one would expect it to be included in every loan contract. Yet the legislature granted this right to overcome persistent information asymmetries in the market for lending. Additionally, the CJEU, in the *Lexitor* judgment, concluded that Directive 2008/48/EC granted consumers the right to partial reimbursement of both recurring and up-front costs of credit in the event of early repayment. While allowing for partial reimbursement of up-front costs can alter consumer decisions leading to market inefficiencies, the European legislature made the pragmatic choice and granted these rights to consumers to overcome information asymmetries.

a) Granting Consumers the Right to Repay Loans Early

In Directive 2008/48/EU the European legislature granted consumers the right to repay loans early. The legislature sought to lay down rules for a world where there are consumers who obtain long-term loans but who, due to events that were unforeseen *ex ante*, no longer need to keep the loans until their natural maturity. In an ideal world with perfect information, both the consumer and the credit institution would be able to accurately determine in advance the optimal duration of the credit relationship. Then the need for an early repayment

provision, as mandated under Directive 2008/48/EC, would not be necessary in a contract. However, because it is often unfeasible to know *ex ante* the ideal duration of the credit relationship, European legislators sought to protect consumers entering into contracts with imperfect information.¹³

Imagining a world with these consumers, the European legislator sought to protect consumers by granting them the inalienable right to make early repayment of loans, allowing them to discharge fully or partially their obligations under the credit agreement at any time.¹⁴ This mandatory rule may be considered efficient as it means that when a loan is repaid in advance by a consumer who no longer needs it, the money can be put to more economically productive uses. But if it were truly efficient, then one would expect this clause to be included in every lending contract.

In a transaction between a rational, perfectly informed consumer and an equally rational, perfectly informed lender, all the contractual terms will be efficient. Thus, a rule allowing the consumer to make early repayment would be instinctively included in the parties' contract, without being imposed as a binding requirement by the legal system. However, the need for a mandatory rule allowing early repayment of loans, as included in Art 16(1) of the Directive, arises from the fact that the consumer may not be perfectly informed. If the consumer is imperfectly informed, the lender could include an inefficient clause in the contract, unbeknown to the consumer, prohibiting the consumer from paying back the loan early. The appearance of inefficient clauses in consumer contracts, permitted by consumers' imperfect information, is commonplace. Thus, the legislature's choice to grant consumers the right to early repayment can be said to be efficient under such conditions, helping to protect consumers from information asymmetries.

b) Directive 2008/48/EC Interpreted to Allow for the Partial Reimbursement of Up-Front Costs of Loans

However, in the *Lexitor* judgment, the CJEU concluded that under Directive 2008/48/EC consumers also have the right to a partial reimbursement of up-front costs in the event of early repayment of loans. If granting consumers the right to early loan repayment, as laid down by Directive 2008/48/EC, can be regarded as efficient in a world where consumers take out loans without knowing whether unforeseeable events will counteract the advantage of keeping the loan until its natural maturity, it is worth verifying whether the interpretive rule laid down by the *Lexitor* judgment on the reimbursability of up-front costs is also efficient in a consumer world such as the one described above, specifically when there is an information asymmetry.¹⁵

¹³ Information is imperfect when it is not complete, ie, full.

¹⁴ European Parliament and of the Council Directive 2008/48/EC, n 1 above, Art 16(1).

¹⁵ A situation of 'asymmetric information' arises when one party to a potential agreement has

It has to be said that the reimbursability of up-front costs produces an expected benefit for the consumer. In the event of early repayment of the loan, the consumer receives a sum of money that would not otherwise have been returned. However, this rule also imposes an expected cost on the lender who, when determining the fee for the service of providing the loan, must take into account all the costs that will be incurred, including the expected costs of fee reimbursement.¹⁶ The consumer will then have to weigh his potential benefit against the fee increase to obtain the loan that will certainly be imposed by lenders under the *Lexitor* rule that up-front costs are partially reimbursable.

If the increase in fee imposed by lenders to provide a loan is higher than the value that the consumer attributes to an early repayment clause, the legislature can be said to have overprotected and ultimately damaged consumers. This would give rise to a heterogony of ends.¹⁷ Suppose we have a lender who by definition is assumed to be risk neutral and a risk-averse consumer who decide to enter into a € 10,000 loan contract for ten years. Also assume that the loan origination costs are € 1,000. The lender incurs these costs, but immediately passes them on to the consumer. If the parties were able to freely negotiate the clauses concerning early repayment of the loan, the question is whether they would include a clause allowing for the pro-rated reimbursement of the up-front costs incurred to set up the loan. The up-front costs are sunk costs, meaning that they are incurred for the purpose of setting up that specific loan and have no potential use outside that relationship.

Imagine that the parties initially agreed on pro-rated reimbursement in the event of early repayment of the loan. Suppose that, given the expectation of reimbursement, there is a fifty per cent probability that the consumer will discharge the loan after five years and a fifty per cent probability that he will keep the loan until its natural maturity. In this case the lender faces a risk equal to $\frac{1}{2}$ (–500) and $\frac{1}{2}$ (0), with an expected monetary value equal to –€250. As the lender is risk neutral, the certainty equivalent of this risk is –€250.¹⁸ Hence,

greater knowledge than the other party.

¹⁶ Early repayment rules also seek to protect the credit institution, as it could enter into a credit relationship on the basis of asymmetric information in favor of the consumer. The information asymmetry arises from the fact that the credit institution does not know which consumers wish to have a sum of money at their disposal for a short period of time, repaying the loan early, and which for a long period of time. A consumer interested in having a sum of money at his disposal for a short period of time may prefer a long-term loan, with the intention of repaying it early, rather than obtaining a short term-loan. Because of the partial reimbursement of up-front costs, the long-term loan may ultimately be less expensive to the consumer but imposes an additional cost on the lender. The lender will raise the cost to obtain a loan to offset this potential loss.

¹⁷ Heterogony of ends is the idea that seeking a certain end goal can cause experiences that modify the original motivation seeking out that goal. In other words, 'the end does not always produce the means, but the means oftener originate the end'. G. Villa, *Contemporary Psychology* (New York: MacMillan Co, 1903), 366-369.

¹⁸ The certainty equivalent in this context is the value required to leave the lender indifferent between the consumer paying the loan after five years and the consumer paying the loan after its

the lender will request a fee increase of €250 from the consumer. For his part, the consumer faces an expected risk of $\frac{1}{2}$ (500) and $\frac{1}{2}$ (0), with an expected monetary value equal to €250. As the consumer is risk-averse, for him the certainty equivalent of this risk is lower than €250.¹⁹ For the consumer, the right to obtain partial reimbursement of the up-front costs of the loan would be inefficient, as the consumer would be forced to pay more for the loan than the consumer would benefit due to the lender's risk that the consumer pays back the loan early. In this case, the consumer would not acquire the loan and the credit market would shrink. Thus, imposing the right to repay loans early and the rule of partial reimbursement, as under the *Lexitor* judgment, while seeking to benefit consumers, could actually end up harming consumers. But because of information asymmetries and possible evasive action by the credit institution, as detailed by the Advocate General and the CJEU, the *Lexitor* rule is the pragmatic choice.

While granting consumers the right to repay loans early and allowing for the partial reimbursement of up-front costs could end up harming consumers and thus be inefficient, so far it has been implicitly assumed that the rule that only recurring costs must be reimbursed is the 'ideal', or efficient, rule. However, only allowing for the reimbursement of recurring costs would give rise to evasive behavior by credit institutions. Thus, the legislature, as affirmed in the *Lexitor* judgment, made the pragmatic choice and granted consumers the right to partial reimbursement of both recurring costs and up-front costs to overcome information asymmetries in the market.

The European Court of Justice in its *Lexitor* judgment reminds that in practice a rule only allowing for the partial reimbursement of recurring costs (to the exclusion of the up-front costs) gives rise to evasive behavior, whereby lenders do not return the recurring costs in the event of early repayment of the loan because they artificially increase the up-front cost items and likewise artificially decrease the recurring cost items.²⁰

Up-front costs are those costs that the lender incurs in processing the loan and preparing the contract. They cease to apply when the contract is finalized. In the language of the *Lexitor* judgment, up-front costs are those that 'do not depend objectively on the duration of the contract'.²¹ Up-front costs are usually incurred by the lender but are then reimbursed by the consumer when the loan contract is concluded.²² In contrast, recurring costs are defined as costs incurred by the lender while the loan is in progress, for example, management costs. In other

natural maturity, in this case €250.

¹⁹ In other words, because the consumer is risk-averse, he is not indifferent to paying €250 to the lender to allow him to either pay the loan after five years or pay the loan after its natural maturity. The consumer would be indifferent only if he pays the lender less than that amount.

²⁰ Case C-383/18, n 6 above, para 31.

²¹ *ibid* para 24.

²² One form of reimbursement of the up-front costs may be paid by deducting these costs from the borrowed sum.

words, they are costs that 'depend objectively on the duration of the contract'.²³ As a rule, these costs are incurred periodically throughout the life of the loan at a constant amount.²⁴

To establish whether allowing for the partial reimbursement of up-front costs would give rise to evasive behavior, it is first necessary to verify whether the result described by the European Court of Justice would actually happen in a competitive market and then to verify whether such a result would give rise to inefficiencies.²⁵

Suppose that a ten-year loan contract entails up-front costs of €500 and recurring costs of €500. Following the reasoning developed by the European Court of Justice and taking it to its extreme, we can assume that lenders will charge up-front costs equal to €1,000 and recurring costs equal to zero.

Imagine that there are two competitor companies that do not collude, and that have adopted the same strategy. As in the previous example, suppose there is a $\frac{1}{2}$ probability that the consumer will repay the loan early after five years.

So, the provision that the recurring costs are equal to zero (in other words that the recurring costs will not be reimbursed) will result in an expected benefit for the lender equal to €250. The same provision, however, will result in an expected loss for the consumer, as he will take a $\frac{1}{2}$ risk of losing €500, when he repays early. The choice facing the consumer therefore has an expected monetary value equal to $\frac{1}{2}$ (0) and $\frac{1}{2}$ (-500), ie, -€250. However, it has been assumed that the consumer is risk averse (since he is unable to diversify the risk across a portfolio of loans); therefore, the expected loss will be higher than -

²³ Case C-383/18 n 6 above, para 24.

²⁴ Recurring costs are usually prepaid to the lender by the consumer by means of deduction from the borrowed sum.

²⁵ It could be argued that the European legislature was not concerned by the effect that establishing the reimbursability of the up-front costs might have, and namely that consumers interested in obtaining a short-term loan would request a long-term loan with the intention of repaying it early and therefore obtaining reimbursement of the up-front costs. The judges in the Court of Justice of the European Union point out that the European legislature's choice was pragmatic and not ideal, due to the various difficulties that would arise if a distinction was made between up-front and recurring costs. But if the European legislature's choice was pragmatic, this means that if it were not for the practical problems in distinguishing between up-front and recurring costs, its ideal choice would have been a different one. And that ideal choice would have been to make only the recurring costs reimbursable. This appears to be the most convincing reconstruction of the European legislature's intent. One might then ask why the ideal choice would be to make up-front costs non-reimbursable. And the answer inevitably lies in the need to prevent consumers interested in short-term loans from actually taking out long-term loans with the intention of repaying them early and obtaining reimbursement of the up-front costs. This conduct is harmful to credit institutions and indirectly to consumers who take out long-term loans with the intention of maintaining them until their due date, as the cost of the early reimbursements will be passed on through the installments these consumers are required to pay. Furthermore, the reimbursability of up-front costs gives rise to considerable inefficiencies, as will be seen in this article. So, if the European legislature's ideal choice would have been to make up-front costs non-reimbursable, it is necessary to go back to it when there are valid reasons, as this would discourage the taking out of long-term loans with the intention of repaying them early.

€250. Assume, for the sake of this example, it is – €400.

Where we have two competing lenders and perfectly informed consumers, the contractual provision setting up-front costs equal to €1,000 and recurring costs to zero will not survive. In fact, one of the two competitors could offer the consumer the correct breakdown of up-fronts costs equal to €500 and recurring costs equal to €500. With this contractual provision, the recurring costs will have to be partially reimbursed in the event of early repayment of the loan and therefore there will be an expected cost for the lender equal to – €250. The consumer on the other hand will obtain an expected benefit equal to €400.²⁶ If the lender were to offer the consumer an amendment of the contract in these terms in exchange for a fee increase equal to €300, for example, both parties would gain.²⁷ Therefore, a clause that would artificially qualify all the costs to be up-front, such that nothing would need to be reimbursed in the event of early repayment, would not be sustainable in a competitive market.

However, the efficient clause will only emerge if consumers are perfectly informed. In this specific case they would have to read the contracts accompanying the loan and understand their clauses. But acquiring knowledge of contracts involves a cost, and this cost may exceed the expected benefit. In this case, consumers will forgo reading and understanding the contract. There will be a form of rational apathy. In the presence of this consumer apathy, it will no longer be worthwhile for lenders to distinguish between up-front and recurring costs, but only to describe all costs as up-front costs. In that way, lenders will not have to reimburse any cost in case of early repayment of the loan, even if some costs are in fact depending on the duration of the contract.

Hence adverse selection will occur and the inefficient clause describing all the costs as up-fronts costs will prevail over the efficient clause making a truthful distinction between up-front costs and recurring costs. The inefficiency will lie in the fact that the clause describing all the costs as up-fronts costs will result in a benefit for the lender of €250 and a cost for the consumer of €400, with a loss of social welfare equal to €150 per contract.

In interpreting Directive 2008/48/EC, the CJEU concluded the European legislature opted for the pragmatic rather than ideal choice because of the practical difficulty in distinguishing between up-front and recurring costs. It may have also opted for this choice to avoid the risk that banks would artificially inflate up-front costs and reduce recurring costs in the presentation of their financial proposals to reduce their exposure to early repayment costs. However, this does not alter the fact that in the absence of these difficulties, the rule

²⁶ Because of the consumer's risk aversion, the benefit of receiving the loan with up-front and recurring costs separately, allowing for the potential of partial reimbursement, is greater than if the consumer were risk neutral.

²⁷ While the consumer must pay more for the loan, because of his risk aversion, he is willing to pay more to have the potential for reimbursement. In this example, the lender will benefit by € 50 and the consumer will benefit by €100.

affording greater protection to consumers and credit institutions should provide for proportional reimbursement of the recurring costs only, while keeping the up-front costs required for creating the debt intact. There would be no reason to set aside the ideal rule where the aforementioned pragmatic reasons no longer applied, but because of the information asymmetries, the legislature chose exactly that, opting for the pragmatic choice.

Because of information asymmetries, the European legislature established that consumers have the right to repay loans early and, as decided in *Lexitor*, the right to partial reimbursement of both up-front and recurring costs. While granting these rights helped overcome the information asymmetries present in lending, it creates several inefficiencies, changing the way consumers act in the credit market.

2. The Inefficiency of the Reimbursability of Up-Front Costs and Origination Fees

While Directive 2008/48/EC overcame information asymmetries in the right to repay loans early and obtain reimbursements of the costs of a loan, in allowing for the reimbursement of both recurring and up-front costs, the *Lexitor* judgment creates several inefficiencies in the market for credit. First, consumers may, instead of obtaining short-term credit, seek out long-term credit with the explicit intention to repay the loan early due to its lower final cost. Second, because of the lower final cost to obtain long-term credit, there may be an overconsumption of credit by consumers who value the loans at lower than their societal cost. While the Directive sought to provide protection to consumers, these inefficiencies may ultimately hurt them.

a) Consumers Fail to Internalize the Costs of a Loan Under Partial Reimbursement of Up-Front Costs

The *Lexitor* judgment granted consumers the right to a partial reimbursement of both recurring and up-front costs in the event of early repayment. But allowing the partial reimbursement of up-front costs in the event of early repayment of a loan means that a person entering into a long-term loan contract with the precise intention to repay it in the short term, and therefore recover the up-front costs, does not internalize (ie incorporate) all of the costs required to provide the specific service of granting the loan. As the costs of providing the service are not fully internalized, a person may well purchase this service even when the private benefit is lower than the social cost. This creates a negative externality, which the consumer fails to take into account, giving rise to an inefficiency.

In deciding whether to purchase a loan, a borrower will compare his own private benefit to his private cost, represented by the sum that will not be recovered when repaying the loan early. If the private benefit is higher than the

private cost, the borrower will purchase the loan. But in some instances, the private benefit is lower than the social cost, ie, the sum of the private cost that the borrower incurs and the private cost that the lender incurs (represented by the cost to be reimbursed). In such instances, when the private benefit is lower than the social cost, the rule providing partial reimbursement of up-front costs, as decided by the *Lexitor* judgment, produces an inefficiency.

To help determine how consumers would behave in a world where up-fronts costs must be partially reimbursed in the event of early repayment of loans, we can first examine the opposite scenario — a situation where there is no requirement to partially reimburse up-front costs in the event of early repayment. This world accurately reflects many European legal systems prior to the *Lexitor* judgment.²⁸

Suppose that consumers can be divided into those seeking a short-term loan (one year) and those seeking a long-term loan (ten years). Suppose also that the up-front costs for a short-term loan are slightly lower than for a long-

²⁸ This includes the Italian legal system. For example, Art 125-*sexies* of the TUB (the Italian Banking Law) provides that consumers are entitled to a reduction in the total cost of the credit in the event of early repayment. Decreto Legislativo 1 September 1993, no 385, Art 125-*sexies* (It). But prior to the *Lexitor* judgment, this provision was consistently interpreted as meaning that up-front costs did not have to be partially reimbursed. This was the opinion expressed by both independent authorities and ordinary courts. After the *Lexitor* judgment, Italian law scholars have considered the issue whether that decision influences the interpretation of Italian law. Some scholars claimed that Art 125-*sexies* of the TUB should now be interpreted in the sense that all the costs must be reimbursed, both up-front and recurring. These scholars maintain that, since the formulation of the EU Directive and Italian law are quite identical, it's not possible to interpret Italian law in a way that is different from the interpretation given by CJEU to Art 16, of Directive 2008/48/EC. That opinion can be found in A. Dolmetta, 'Anticipata estinzione e "riduzione del costo totale del credito."' Il caso della cessione del quinto' *Banca Borsa Titoli di Credito*, II, 639 (2019). The same idea is expressed by A. Tina, 'Il diritto del consumatore alla riduzione del costo totale del credito in caso di rimborso anticipato del finanziamento ex art. 125-*sexies*, primo comma, t.u.b. prime riflessioni a margine della sentenza della Corte di Giustizia dell'Unione europea' *Rivista di Diritto Bancario*, 155, 166 (2019).

A different idea is formulated by A. Zoppini, 'Gli effetti della sentenza *Lexitor* nell'ordinamento italiano' *Banca Borsa Titoli di Credito*, 1, 11 (2020), who states that, since the Italian regulatory system and the role of independent authority (Banca d'Italia) prevent lenders from manipulating upfront costs, Italian law should be interpreted so that only recurring costs must be reimbursed.

An important decision has been issued by Arbitro Bancario Finanziario, Collegio di Coordinamento, 17 December 2019 no 26525. It states that all costs must be reimbursed because the Italian law can be interpreted only in this way. Indeed, every Italian judge has a duty to interpret Italian law in a way that it results in a meaning that conforms to European law (obbligo di interpretazione conforme), and the formulation of Art 125-*sexies* of the TUB permits this interpretation.

At this moment the Supreme Court has not given a solution to the problem. Some judges have stated that Art 125-*sexies* of TUB can be interpreted in a way the is compatible with the *Lexitor* judgment while others have stated that it's not possible.

In the former sense, see Tribunale di Napoli 29 June 2020 no 4433, available at www.dejure.it; Tribunale di Torino 22 September 2020, available at www.dejure.it and Tribunale di Milano 3 November 2020, available at www.dejure.it.

In the latter sense, see Tribunale di Napoli 10 March 2020 no 2391, available at www.dejure.it; Tribunale di Mantova 30 June 2020, available at www.dejure.it and Tribunale di Roma 11 February 2021, available at www.dejure.it.

term loan. Let us assume that for a short-term loan the up-front costs are equal to €4,000, while for a long-term loan they are equal to €5,000. In the world that is being considered, that is, where the rule enshrined in the *Lexitor* judgment does not exist and up-front costs are not reimbursed, consumers seeking short-term financing will take out loans with a short-term maturity (one year), incurring up-front costs of €4,000. In contrast, consumers seeking long-term financing will take out loans with a ten-year duration, incurring up-front costs of €5,000. Both categories of consumers will internalize all of the up-front costs to determine which type of loan to take out, as no form of recovery is envisaged. This results in consumers self-separating.

But consumers will behave in a considerably different manner if it is established that up-front costs must be partially reimbursed in the event of early repayment of loans, as under the *Lexitor* rule. Suppose that the *pro rata temporis* principle²⁹ is applied to calculate the sum to be reimbursed for up-front costs. This means that a consumer who enters into a ten-year loan contract, initially paying €5,000 for the up-front costs incurred by the intermediary, will obtain a reimbursement of €4,500 if he repays the loan after one year.³⁰ In other words, the final cost of the loan would be equal to €500. Thus, operating under a rule imposing partial reimbursement of up-front costs means that all consumers seeking one year financing who, in the absence of this *Lexitor* reimbursement rule, would have taken out one-year loans, will instead find it advantageous to take out ten-year loans with the precise intention to repay them after one year, recovering a large portion of the up-front costs and significantly reducing their private costs of obtaining a loan. When taking out a long-term loan with the intention to repay it early reduces the cost of the loan for the consumer, every consumer would adopt this strategy, even though this would create higher overall costs of loan creation for the bank.³¹

The ability for consumers seeking one-year financing to take out a ten-year loan with the precise intention to repay it after one year arises from the information asymmetry between consumers and lenders. Indeed, when faced with a consumer requesting a ten-year loan, lenders have no way of knowing whether the consumer is someone who intends to repay the loan in advance or is someone who intends to

²⁹ The *pro rata temporis* principle means that the consumer is reimbursed at the proportional rate for the amount of time that the consumer keeps the loan for. For example, if the consumer repays a ten-year loan after one year, he is entitled to a reimbursement of nine-tenths of the costs.

³⁰ Since it is otherwise a ten-year loan and the consumer pays the loan back after one year, the consumer is entitled to a reimbursement of nine-tenths of the up-front costs of the loan, or €4,500.

³¹ This switch between seeking short-term credit and long-term credit with the explicit intention to repay it in the short term is termed the 'switching effect'. The 'switching effect' will only occur if the up-front costs for ten-year loans are not much higher than those of one-year loans. For example, if the up-front costs for one-year loans are equal to €1000 while those for ten-year loans are equal to €12,000, this switching effect would not occur, as the cost to repay a ten-year loan early would cost €200 more than a one-year loan. Accordingly, consumers seeking one-year financing would enter into loan contracts with one-year maturity.

keep it until its natural maturity. If lenders could identify consumers intending to repay the loan after one year, they would refuse to enter into a long-term loan with them or would only offer them a loan with a one-year maturity.³² However, given current legislative restrictions, there is no way for lenders to discern one type of consumer from another.

Thus, under the *Lexitor* rule, consumers may be incentivized to purchase long-term credit with the explicit intention to repay the loan early, despite only seeking short-term credit in the absence of such a rule. And because credit institutions cannot distinguish between consumers, they will need to increase the costs for consumers to obtain credit to compensate for the potential reimbursement of the up-front costs of loans. This creates an inefficiency in the market.

b) Partial Reimbursement of Up-Front Costs May Lead to Over-Consumption of Long-Term Credit

Until now the focus has been on the behavior of consumers who seek a one-year loan, but instead, under the *Lexitor* rule, take out a ten-year loan with the undisclosed intention to repay the loan at an earlier time, given the reimbursability of the fixed origination costs. However, requiring the partial reimbursement of the up-front costs can lead to an overconsumption of credit. The rule can incentivize consumers who otherwise would not obtain a loan (low-valuing consumers) to enter the market and purchase credit despite valuing it less than its social cost, creating a second inefficiency.

By creating a discrepancy between the private cost faced by the consumer and the actual total cost of loan origination faced by the bank, ie, the social cost, the *Lexitor* rule can encourage consumers who might not otherwise seek a loan to obtain one, leading to an overconsumption of lending. For example, let us again assume the up-front costs for a one-year loan equal €4,000. Consumers who choose a long-term loan instead of a short-term loan will accordingly value the loan to be at least €4,000.³³

The introduction of the *Lexitor* rule allowing for the partial reimbursement of up-front costs will lead some consumers who value the loan less than €4,000 and might not otherwise take out a one-year loan, to purchase one. In a market without the rule of partial reimbursability, given the lower benefits obtained in the short term of a one-year loan, consumers would not justify incurring the high up-front costs. But under the *Lexitor* rule, because part of the high up-

³² Due to asymmetric information, the credit institution cannot know whether the consumer is interested in having a sum of money at his disposal for a short period of time, an interest achieved by taking out a long-term loan with the intention of repaying it early and recovering the up-front costs, or whether the consumer is really interested in a long-term loan. If there was no asymmetric information, the credit institution would refuse the loan to the consumer intending to make early repayment, thus obliging him to take out a short-term loan.

³³ This assumes the long-term loan has higher up-front costs than the short-term loan.

front costs are reimbursable, consumers may justify taking out long-term loans with the intention to repay them early, lowering the private cost of obtaining a loan.³⁴ This solution will be adopted by consumers for whom the private benefit obtained from a loan is higher than the private cost they incur. In the example considered, this cost is equal to €500 (consumers pay €5,000 in up-front costs but recover €4,500). As a result, any consumer who obtains a benefit of more than €500 from a loan will request a long-term loan with the intention to repay it after one year. Accordingly, any new borrowers who value the one-year loan at between €500 and €4000 will enter into the market for long-term loans. But obtaining such a long-term loan imposes a social cost. This social cost is equal to the up-front costs of €5,000, which outweighs the private benefit of between €500 and €4,000. Here, a very clear inefficiency can be observed.

It must therefore be said that the introduction of the rule as enshrined in the *Lexitor* judgment into a world where the reimbursement of up-front costs is not required will create two negative consequences. First, consumers who would have otherwise taken out a one-year loan will now take out a ten-year loan with the intention to repay the loan early. Second, the rule will now incentivize consumers who would never have obtained a loan prior to this rule to enter the market because the private benefit will exceed the private costs after reimbursement, despite the high social cost. In other words, allowing for the partial reimbursement of up-front costs in addition to recurring costs, as under the *Lexitor* rule, will lower the costs to obtain a loan, leading to an overconsumption of credit by low-valuing consumers. Hence, a rule such as the one enshrined in the *Lexitor* judgment may produce at least these two inefficiencies in the credit market. However, while the *Lexitor* judgment may create these inefficiencies, the European legislature and the CJEU chose this rule because it was the pragmatic choice. While these inefficiencies may arise as part of consumer behavior, legislatures can choose to mitigate these inefficiencies by limiting what up-front costs are eligible for reimbursement. As described in the next section, by choosing to exclude from reimbursement the up-front costs for non-mandatory ancillary services, the legislatures can mitigate adverse consumer incentives in the credit market.

III. Reimbursability of Other Non-Mandatory Ancillary Services

As discussed in the previous sections, a rule imposing the mandatory partial reimbursement of up-front costs in addition to recurring costs can lead to several inefficiencies. Because consumers do not internalize the full costs when partially reimbursed in the event of early repayment, they may enter into long-term loans when only seeking short-term lending, or consumers may

³⁴ Again, this assumes that a long-term loan has higher up-front costs than a short-term loan.

obtain loans they might otherwise purchase, imposing a social cost on others. However, as detailed by the Advocate General and the CJEU, the European legislators chose the pragmatic option in allowing for reimbursement of the up-front costs.³⁵ One natural extension to the reimbursement of up-front costs is whether the European legislators also sought to allow for the reimbursement of up-front, non-mandatory third-party services, that is, those services voluntarily purchased by consumers in obtaining the loan. As detailed in this section, both the legislative intent and economic considerations lead to the conclusion that non-mandatory ancillary services should not be eligible for reimbursement in the event of early loan repayment. Excluding voluntarily incurred costs from eligibility for reimbursement in the event of early repayment helps to mitigate the inefficiencies in the credit market that arise under the *Lexitor* judgment. There might be some concern that this view cannot take into account the possibility that the formal ‘non-compulsory’ nature of additional costs may often times be a mere façade, over which the consumer has no control. Indeed, lenders could bundle these services. But it’s worth noting that, according to Art 3 of the Directive 2008/48/EC, an ancillary service is ‘non-compulsory’ only if the conclusion of a service contract is not necessary in order to obtain the credit or ‘to obtain it on the terms and conditions marketed’.

1. Directive 2008/48/EC Excludes the Reimbursement of Non-Mandatory Services Offered by Third Parties in the Event of Early Repayment

The European legislature, in Directive 2008/48/EC, provided consumers with the right to repay a loan early and to receive a partial reimbursement of both the up-front and recurring costs of the loan. But there is an open question of whether the legislature intended this to include up-front costs of non-mandatory ancillary services, that is, services voluntarily purchased along with the loan, eg, insurance services. These costs should not be eligible for partial reimbursement in the event of early loan repayment. Excluding such costs from reimbursement carries out the intent of the legislature and mitigates the economic inefficiencies detailed previously, which would otherwise be present in the credit market.

Directive 2008/48/EC, as discussed earlier, states in part that consumers

shall be entitled to a reduction in the total cost of the credit, such reduction consisting of the interest and the costs for the remaining duration of the contract.³⁶

The total cost of the credit, as outlined in Art 3 *g*) includes

³⁵ Case C-383/18, n 6 above, paras 33-34, 53, 55, 63-65, 68.

³⁶ European Parliament and of the Council Directive 2008/48/EC, n 1 above, Art 16(1).

interest, commissions, taxes and any other kind of fees' for ancillary services if 'the conclusion of (that) service contract is compulsory in order to obtain the credit or to obtain it on the terms and conditions marketed'.³⁷

A literal interpretation of the Directive 2008/48/EC suggests that, if the definition of reimbursable up-front costs includes the services that the credit institution prescribes as mandatory to obtain the credit, then it accordingly *does not* include the costs of other ancillary services offered by third parties that the credit institution does not prescribe as mandatory. According to the operative part of CJEU's judgment in *Lexitor*,

Article 16(1) of Directive 2008/48/EC ... must be interpreted as meaning that the right of the consumer to a reduction in the total cost of the credit in the event of early repayment of the credit includes all the costs *imposed* on the consumer.³⁸

An inattentive reading of the decision could lead to the view that the EU Court did not wish to introduce any distinction between costs, meaning that even the costs of non-mandatory services should be proportionally reimbursed along with all other up-front costs. However, the operative part of the judgment must be interpreted carefully and in light of the statement of reasons for the ruling.

Firstly, the operative part makes a clear reference to the costs 'imposed' on the consumer (ie, the costs for the services that the bank requires the consumer to purchase to obtain the credit), but not to those that the consumer bears voluntarily (ie, non-mandatory ancillary services purchased from third parties).³⁹ In describing which costs are reimbursable, the explicit usage of the 'total cost of the credit' in para 23 of the CJEU judgment makes express reference to Art 3(g) of the Directive, under which the costs borne by consumers are proportionally reimbursable 'if ... the conclusion of a service contract is *compulsory* in order to obtain the credit or to obtain it on the terms and conditions marketed'.⁴⁰ In light of Art 3 g) of the Directive, the operative part of the *Lexitor* judgment must therefore be read as meaning that the cost of non-mandatory ancillary services must be excluded from the definition of 'total cost of the credit' because they are not compulsory to obtain credit. Therefore, they must not be eligible for reimbursement in the event of early repayment.

It is also necessary to bear in mind that, as expressly ruled by the CJEU, the Court's interpretation of the term 'total cost of the credit' was established by taking into account the fact that the consumer protection system, set up by the Directive, 'is based on the idea that the consumer is in a weak position vis-à-vis

³⁷ European Parliament and of the Council Directive 2008/48/EC, n 1 above, Art 3 g).

³⁸ Case C-383/18, n 6 above, para 36 (emphasis added).

³⁹ *ibid* para 36.

⁴⁰ *ibid* para 5 (emphasis added).

the seller or supplier, as regards both his bargaining power and his level of knowledge'.⁴¹ If we consider the objective pursued by the European legislature, namely that of protecting the consumer with regards to the ancillary services imposed by the credit institution, then the costs that the consumer decides independently to incur must not be reimbursed in the event of early repayment.

Thus, interpreting the operative part of the *Lexitor* judgment in the light of its statement of reasons, the consumer's entitlement to the reimbursement of the proportional cost of the credit in the event of early repayment of the credit includes all of the costs that the consumer *must* incur, but excludes those for ancillary services purchased by the consumer voluntarily, ie, those services not imposed on him by the credit institution to obtain the credit or to obtain it on the terms and conditions marketed.

Non-mandatory ancillary services include, with greater reason, those purchased independently by consumers and offered by third parties rather than directly by the credit institution.⁴² For example, these services include the cost of financial advice, intermediation, and additional insurance that are not required by the credit institution, but the consumer chooses to purchase. According to the aforesaid legislation and statement of reasons in the *Lexitor* judgment, the cost of non-mandatory services must be excluded from the costs eligible for reimbursement by the credit institution in the event of early repayment of the loan.

While the operative part of the *Lexitor* judgment, interpreted in light of its statement of reasons, leads to the conclusion that non-mandatory ancillary services are not reimbursable in the event of early credit repayment, this interpretation also falls in line with the pragmatic considerations made by the Advocate General and upheld by the CJEU. One objection raised by the Advocate General noted that in the event of a dispute, the distinction between up-front costs and costs dependent on the duration of the loan, ie, recurring costs, would require national courts to call on the services of accounting experts.⁴³ However, the need to obtain outside experts is not necessary for understanding the costs of non-mandatory services offered by third parties. Because these services are, in fact, services that are not offered by the credit institution itself, but by other entities, the costs are fully independent of those of the credit institution, and therefore are easily distinguishable *ex post*.⁴⁴ Therefore, allowing for the reimbursement

⁴¹ Case C-383/18, n 6 above, para 29 (citing C-377/14, *Radlinger and Radlingerová*, EU:C:2016:283, para 63).

⁴² The services offered by third parties cannot be inflated or manipulated to the advantage of the credit institution, the conclusion of a service contract is compulsory in order to obtain the credit or to obtain it on the terms and conditions marketed and forcing the lenders to reimburse the cost of those services would impose an even greater externality on borrowers who do not exercise early repayment.

⁴³ Case C-383/18, n 6 above, para 54.

⁴⁴ Because the consumer will receive a defined price when choosing to purchase a non-mandatory ancillary service from third parties, an estimation of the cost is not needed when

of these types of costs was not within the scope of the Advocate General's or CJEU's intent.

Similarly, the Advocate General's and CJEU's concern that credit institutions could use their discretion in invoicing costs to increase up-front costs to the detriment of recurring costs,⁴⁵ when applied to non-mandatory ancillary services, is not applicable for two obvious reasons. First, because the lending intermediary has no direct control over the prices of services offered by third parties, it does not benefit from any increase in the price of these services aimed at creating a nominal reduction in the reimbursable costs linked to the duration of the loan. Second, unlike the mandatory services governed by Directive 2008/48/EC, if the price of the non-mandatory services offered by third parties were artificially increased, the consumer demand to purchase such services would fall, resulting in the opposite effect to the one intended by the credit institution.⁴⁶ Accordingly, these costs were outside the consideration of the legislature and should not be eligible for partial reimbursement.

Interpreting the *Lexitor* judgment in light of its pragmatic considerations, the European legislature did not intend for the partial reimbursement of non-mandatory ancillary services in the event of early loan repayment as these incurred costs are voluntary. The European legislature only sought to allow for the partial reimbursement of *compulsory* costs. This conclusion is further supported by economic considerations. As detailed in the next section, even if it appears that the European legislature's decision was designed to protect credit institutions—by making the cost of non-mandatory services non-reimbursable in the event of early withdrawal—the decision is a legislative choice that, above all, protects consumer welfare and fosters economic efficiency. After all, as stated in Recital 7 of the Directive, the aim of the European legislation was to 'facilitate the emergence of a well-functioning internal market in consumer credit'.⁴⁷

2. Economic Inefficiency of the Reimbursement of Up-Front Costs for Non-Mandatory Services Offered by Third Parties

The exclusion of up-front costs that are voluntarily purchased by consumers from eligibility for partial reimbursement in the event of early repayment also

determining any reimbursement of costs. Accordingly, these services fall outside the scope of the Advocate General's concern, ie, non-mandatory ancillary services are not meant to be included in any potential reimbursement of costs.

⁴⁵ See above Section II, 1, a).

⁴⁶ The credit institution, if it sought to maximize profits, would actually achieve the opposite effect to the one intended. Supposing that the credit institution arranges with the third party to artificially increase the fee for ancillary services offered by the third party, at the same time reducing the nominal amount of the recurring costs borne by the credit institution, this could lead to a decrease in the purchase of the ancillary services offered by the third party, leaving the credit institution unable to recover the recurring costs.

⁴⁷ European Parliament and of the Council Directive 2008/48/EC, n 1 above, pmb1 7.

follows from economic considerations. The Advocate General and the CJEU, both in their statement of reasons, detailed that the European legislature chose the pragmatic rule rather than the ideal rule. If non-mandatory ancillary service costs were reimbursable, it would create several negative externalities. First, allowing for the reimbursement of voluntarily incurred costs would impose higher costs onto other consumers. Second, because the costs of providing loans may rise, the long-term credit market could shrink. Finally, if, in response to the allowing partial reimbursement of non-mandatory up-front costs credit institutions chose to not enter into contracts with consumers purchasing such services, the market for third party services would become inefficient.

a) Inefficiency Caused by Early Paying Consumers Passing Costs onto Other Consumers

The conclusion that under Directive 2008/48/EC, the costs for non-mandatory ancillary services purchased from third parties should not be reimbursed follows from a specific logic of efficiency. Specifically, it helps mitigate the inefficiencies in consumer behavior when overconsuming long-term loans as described in Section 2. The efficiency of this rule can be illustrated by the following example. For the sake of simplicity, imagine the case of a twenty-year credit relationship with a total value of €1,000, repayable in twenty installments of €50. Suppose that the cost of the non-mandatory ancillary services offered by third parties is equal to €100. Consider a credit institution with a pool of consumers, thirty percent of whom intend to exercise the right of early withdrawal after payment of the first installment. Also, suppose that the ancillary service has a full value for consumers who intend to maintain the credit until its natural expiry, and it has a reduced value, lower than the price of the service itself, for consumers who intend to make an early repayment. Consider the two alternative rules.

Rule 1. Non-reimbursability of the costs relating to non-mandatory services offered by third parties.

Under this first rule, any non-mandatory ancillary service offered by third parties will only be purchased by consumers who are interested in it and who value it more than the requested price. The cost of the credit relationship remains equal for all consumers, €1,000, with installments of €50. Furthermore, presuming the service only has a special value for consumers who intend to maintain the loan until its natural expiry, for example, an additional insurance service, consumers will make different choices. Those who intend to maintain the loan for its full duration will purchase the ancillary service, while those who intend to repay it early will not purchase the service. Since early paying consumers know they will not receive a partial reimbursement if repaying the loan early, there will be no benefit to purchasing the ancillary service but not fully utilizing it over the duration of the loan. Hence, there will be no inefficiencies. Only those who

actually value the service at its consumer price will purchase the service.

Rule 2. Reimbursability of the costs relating to non-mandatory services offered by third parties.

In contrast, under this second rule, the pool of consumers will not make different choices, leading to inefficiencies. Consumers who intend to exercise the right of early repayment will purchase the non-mandatory ancillary service, regardless of the value they attach to it, expecting that the price paid for the service will be proportionally reimbursed upon repayment. The non-mandatory service offered by third parties would therefore be purchased by consumers who value it less than its original cost in addition to the purchasers under Rule 1.

So, for example, suppose that the non-mandatory service consists of mediation. The cost of mediation is €100. Even though the benefit is of little value to a consumer who intends to pay off the twenty-year loan after the first installment, he will still purchase it, trusting that the cost of the mediation will be reimbursed upon early repayment. Hence, there will be inefficiencies.

The decision to make the up-front cost of non-mandatory services reimbursable, which at first appears to be an extension of legislation to protect consumers, would instead harm consumers who use the credit facility for its original duration. Because all consumers will purchase the non-mandatory service offered by third parties, the consumer cost of a loan will rise. Indeed, the credit institution will have to consider the proportional reimbursement of services purchased by consumers when those consumers exercise the right of early repayment. Imagine a pool of 100 customers with 30 customers exercising the right of early repayment. In the example considered above, the installments would increase from €50 to €51.99 for all contracting parties.⁴⁸ Those who exercise the right of early repayment, receiving proportional reimbursement of the optional services they purchased, would impose an unwanted cost (ie, a negative externality) on those who instead remain bound by the credit relationship for its entire duration.

In social terms, there will also be a waste of resources because consumers will use the third-party, non-mandatory service even though they value the service less than its cost.⁴⁹ The costs of most of the non-mandatory services, even if not reimbursed to the consumer, cannot be reversed or recovered from a social point of view. Because these costs are incurred up-front, overconsumption of the service

⁴⁸ In calculating the reimbursement made to consumers who made early repayment, the *pro rata temporis* principle was applied, under which the credit intermediary reimbursed €95 to each one. In a pool of one hundred customers, the sum reimbursed to the thirty customers who made early repayments is equal to €2,850. When the cost of these reimbursements is passed on ex ante to all 1430 remaining installments, each installment increases by €1.99.

⁴⁹ Consumers who value the service less than the cost will purchase the service if they plan to repay the loan early if they value the benefit of the service more than the amount of costs not reimbursed upon early repayment (essentially, if the lowered 'cost' of the service is below the consumer's benefit). As discussed previously under Rule 1, if the consumer would not receive partial reimbursement, they would not purchase the service at the full 'cost' because the benefit is lower.

can lead to costs on others. By overconsuming, those consumers who value the service less than its cost can keep other, higher-valuing consumers from obtaining the service. In other words, low-valuing consumers impose a social cost, leading to inefficiencies in the credit market.

As discussed, when a consumer who intends to make early repayment purchases a non-mandatory service, the cost of the service passes on to all consumers through an increase in the consideration. In the scenario discussed previously, this cost is equal to €100. If the value assigned to the non-mandatory ancillary service is lower than €100, the consumer's overall welfare will decrease. So, if a consumer intending to make early repayment assigns the non-mandatory ancillary service a value of €10, on account of it being passed on to consumers through an increase in the cost of €100, the welfare (in other words their wealth) of the other consumers who maintain the loans for the full term will decrease by €90. In aggregate terms, allowing for the reimbursability of the costs of third-party, non-mandatory ancillary services will normally reduce the consumers' welfare. Paradoxically, in terms of distribution, the rule will benefit consumers who repay the loan early, providing them a partial reimbursement, by passing on the cost of the reimbursement to those who remain bound by the original terms of the credit agreement. This creates an inefficient market for third-party services.

In sum, if partial reimbursements of the up-front costs of non-mandatory services purchased from third parties were allowed, it would create an inefficient market. Consumers who repay the loan would impose an unwanted cost on those who retain a loan for its natural duration in the form of higher installment costs. It would also impose a social cost by reducing overall social welfare, as consumers would purchase the service even though they value it less than its cost. Thus, to avoid this inefficiency, and as supported by the intent of the European legislature, partial reimbursements of up-front costs of non-mandatory ancillary services should not be permitted. This aligns the incentives of consumers and also mitigates the inefficiencies described in Section 2 that arise by imposing the requirement of partial reimbursement of at least some up-front costs when repaying a loan early.

b) Long-Term Credit Market Could Shrink Under Market Inefficiencies

Second, allowing for the partial reimbursement of the costs of non-mandatory ancillary services in more extreme cases could raise the problem previously addressed by the economists Joseph Stiglitz in his work published with Andrew Weiss, 'Credit Rationing in Markets with Imperfect Information',⁵⁰ resulting in

⁵⁰ J.E. Stiglitz and A. Weiss, 'Credit Rationing in Markets with Imperfect Information' 71 *American Economic Review*, 393-410 (1981).

a contraction of the long-term credit market. By excluding the costs of these services from possible reimbursement in the event of early repayment, consumers' incentives to purchase a long-term loan when seeking short-term lending will be reduced.

Consider the example used above of a credit intermediary with a pool of customers who have taken out long-term loans. The intermediary has set the requested installment, bearing in mind that a percentage of the customers will pay the debt off early, requiring reimbursement of the service costs. The intermediary will set a higher installment cost to offset the costs created by customers who opt for early repayment. However, this higher installment cost will mostly be borne by consumers who intend to maintain the long-term loan agreement. It will only have a marginal impact on consumers who intend to pay the loan off in the short term.⁵¹ The increased installment cost will therefore discourage a higher portion of consumers from requesting the loan who intend to maintain the long-term loan agreement until its natural expiry. The withdrawal of these consumers from the pool of consumers will cause the percentage of customers intending to make early repayment to increase. In response, the credit intermediary will have to deal with a higher percentage of early repayments than anticipated and will have to set an even higher installment price for subsequent agreements. This new installment price will compel even more potential customers intending to maintain the long-term credit until its natural expiry not to request the loan. In this way, the long-term consumer credit market will gradually shrink. In essence, long-term consumers would be penalized by externalities created by consumers who pay loans off early, creating a problematic imbalance in the capital market. This would create an inefficient market by shrinking the availability of long-term credit, all driven by consumers obtaining long-term credit to satisfy short-term credit needs.

But, if as proposed here, the costs of non-mandatory ancillary services are excluded from possible reimbursement in the event of early repayment, the inefficiency of reimbursing up-front costs as required under the *Lexitor* judgment can be mitigated. Only those consumers who value a given service at or above its social cost will purchase it. Accordingly, any increase in installment cost necessary to offset the possible reimbursement of costs to customers who opt to repay the loan early will be minimized.

As seen by this discussion, allowing for partial reimbursement of the costs of non-mandatory ancillary services can create several inefficiencies. It can harm those consumers who intend to keep long-term loans until their natural expiry by increasing the costs of obtaining a loan. It could also lead to the market for long-term loans to shrink, again hurting consumers. To avoid these

⁵¹ Because the price of every installment for all consumers will increase, those who pay off the loan early only pay a fraction of the overall increase in cost, while those who pay off the loan over all the original installments face the full increase in cost.

negative externalities, and as intended by the European legislature, the partial reimbursement of non-mandatory services purchased from third parties in the event of early repayment should not be permitted.

c) Lender's Refusal to Enter into the Contract Can Create an Inefficient Market for Third Party Services

Despite the preceding discussion, there is the possibility that these supposed inefficiencies could disappear as the result of evasive action on the part of lenders. Under a rule allowing for the partial reimbursement of non-mandatory ancillary services, lenders may well refuse to enter into loan contracts with consumers who have purchased these services because they may have to partially reimburse the costs in the event of early repayment of the loan. As a consequence, consumers would be incentivized to no longer purchase that specific ancillary service (consider, for example, ancillary services such as insurance policies). However, this evasive action would not eliminate all the inefficiencies caused by the *Lexitor* rule.

In fact, if on the one hand the ancillary service would no longer be purchased by consumers who value it less than its cost – which would increase efficiency – on the other hand, it would also result in those consumers who value it more than its cost to decide not to purchase it. In this case an inefficiency would remain. So, even if the ancillary service were to disappear from the market because lenders refuse to enter into loans with persons who purchased this service, an inefficiency would still exist as consumers who value the ancillary service more than its cost would forgo the service.

Accordingly, if the *Lexitor* judgment were to allow for partial reimbursement of costs of non-mandatory services offered by third parties, the lenders, by refusing to contract with consumers who purchase third-party services, would create an efficiency. If, on the other hand, as is described earlier, the *Lexitor* judgment *excludes* partial reimbursement of costs of these services, then this inefficiency will not be present, as consumers will only purchase the service if they realize the full benefit, and lenders will not refuse to enter loan contracts due to fear of having to repay part of the costs.

Thus, the inefficiencies of allowing for the partial reimbursement of non-mandatory services offered by third parties under the *Lexitor* judgment show that such an interpretation is economically undesirable. This supports the legislature's intent as described by the pragmatic considerations discussed by the Advocate General and the CJEU. By granting the right to early repayment and a pro-rated reimbursement in the event of early repayment of both up-front and recurring costs under Directive 2008/48/EC and the *Lexitor* judgment, the legislature overcomes the information asymmetries present in the lending market. But as discussed in this section, that can lead to its own inefficiencies. To mitigate these inefficiencies, the partial reimbursement of voluntarily purchased

services from third parties under the *Lexitor* judgment should not be permitted.

IV. Concluding Thoughts on the Interpretation of Directive 2008/48/EC

The legal and economic points made above lead to a convergent conclusion on how best to interpret European Directive 2008/48/CE, considering the fact that the European legislature sought to foster the ‘emergence of a well-functioning internal market in consumer credit’.⁵² With regard to the economic treatment of consumers who wish to ‘discharge fully or partially their obligations arising from the credit agreement before the due date’, the favored interpretation must follow the provisions set forth in Art 3 g) of the Directive.⁵³ More specifically, a consumer exercising the right of early repayment will be entitled to a pro-rated reimbursement of the costs that the intermediary prescribes as mandatory to obtain the credit from the credit institution. However, this right must not extend to the cost of ancillary services supplied by third parties that are not required by the credit institution, such as, the cost for financial advice and mediation or for non-mandatory additional insurance.

The inclusion of the costs of non-mandatory ancillary services supplied by third parties among those eligible for reimbursement in the event of early repayment would lead to misuse of the long-term credit facility. It would also lead to the excessive purchase of non-mandatory ancillary services by those intending to exercise the right to make early repayment provided for by European legislation, as described previously.

The long-term credit facility would be misused as consumers wishing to have short-term availability of a sum of money will find it advantageous to enter into long-term loan agreements, envisaging early repayment. This would allow them to proportionally recover all the costs, including the up-front costs (in the scenario examined, the costs for services purchased voluntarily from third parties), making long-term loans cheaper than short-term loans.

The excessive use of non-mandatory ancillary services, coupled with the rule of early repayment with reimbursement, would lead to the creation of negative externalities by those using the credit in the short term to the detriment of those using the credit for its natural duration, in other words, the long term. Whenever an activity creates negative externalities, it will be pursued more than the socially optimal level. Indeed, it will even be implemented when the private benefit is lower than the social cost. Hence, there will be excessive purchasing of non-mandatory ancillary services offered by third parties. To avoid

⁵² European Parliament and of the Council Directive 2008/48/EC, n 1 above, pmbl 7. Even the *Lexitor* judgment reminds, in para 4, that the Directive seeks to create the ‘emergence of a well-functioning internal market in consumer credit’. Case C-383/18, n 6 above, para 4.

⁵³ European Parliament and of the Council Directive 2008/48/EC, n 1 above, Art 3 g).

this and adhere to the European legislature's intent, the partial reimbursement of non-mandatory ancillary services should not be permitted under the *Lexitor* judgment.

V. Conclusion

Upon examining the incentives under the *Lexitor* rule, we can say that the introduction of a rule under which up-front costs must be partially reimbursed in the event of early repayment of loans will produce inefficiencies compared to the ideal world where only recurring costs must be returned. But the existence of this ideal world necessitates the impossibility of evasive behavior on the part of lenders. If evasive behavior can be implemented because consumers are not informed, then the state of the world that emerges with the rule of reimbursement of only recurring costs will be affected by inefficiencies. These inefficiencies will arise from the fact that the prevailing market clause will effectively establish that not even recurring costs must be returned.

So, it is a matter of choosing the second-best solution. The *Lexitor* judgment opted for the rule that even up-front costs must be reimbursed. The inefficiencies produced by this rule could be limited by making the up-front costs items that cannot be artificially increased by lenders non-reimbursable. In other words, non-mandatory ancillary services, those voluntarily purchased by the consumer, should not be eligible for partial reimbursement in the event of early repayment. This conclusion follows from both the intent of the legislature as well as the economic considerations, namely the inefficiencies that arise if reimbursement of the costs of these services were mandatory.