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## From Consumer Credit, Debt & Bankruptcy (2009)

### *Introduction*

JOHANNA NIEMI, IAIN RAMSAY, WILLIAM C WHITFORD

**T**HIS IS A book about credit, debt and trouble. The authors of the book do research on overindebtedness, that is, on situations in which the debt burden of an individual has become overwhelming. Some of them also work closely with debtors or institutions, organizations and people who help those that are overindebted. Thus, they have seen the downside of credit. Yet the authors also see credit as a positive force in society. As Professor Jose Reinaldo Lopez put it at the conference from which the articles in this book originate, credit can and should be used as an inclusive factor that promotes inclusion of people to society. The real issue is how credit is used and how it changes societies. In an idealistic but at the same time conservative vein Udo Reifner argues that credit should be productive.

As the now-extensive research on overindebtedness shows, credit has not been productive for all debtors. During the past two decades we have seen an overall trend that has increased the income and wealth gap between the rich and the poor. While credit and debt are resources that can and do help poor and middle-class families to improve their lot, they also make the circumstances of many families much worse, even causing a regression from the middle to the lower classes. The current crisis stemming from the US housing market is a prime example of that. Ordinary people have also suffered from the economic crises over the past two decades in many other parts of the world, for example in Europe in the early 1990s and in the Asian countries in the late 1990s.

Each of these overindebtedness crises has had an impact on the regulation of consumer overindebtedness and insolvency but the impact has varied in different countries and different parts of the world. This book has resulted from a long-term commitment by the authors of this introduction and many others that a comparative study is fruitful in understanding consumer overindebtedness, the reasons for it and possible legal responses to it. This commitment has resulted in an informal network of academics and activists from around the world, many of whom met in Berlin in July 2007 as part of the meetings of the Law and Society Association. Over 30 papers on overindebtedness were presented and discussed, by approximately 50 participants. All papers included in this book were first presented at this Berlin conference. All papers took some kind of socio-legal approach to the topic, and many included the results of original empirical research.

Earlier meetings on the effects of consumer overindebtedness have tended to focus on insolvency law.<sup>1</sup> For the Berlin meetings and for this book a conscious and successful effort was made to expand the range of papers. The globalization of the credit markets has continued and lending by international lenders has gained new consumer markets in different parts of the world, especially Central and Eastern Europe, Latin America and Asia. At the same time, lenders have been looking for new market segments in the mature credit societies, adapting the loans to the means and possibilities of the new borrowers. Part 1 of this book contains several Chapters describing these developments in consumer credit markets in different parts of the world.

Part 2 of the book contains Chapters focusing on new attempts to regulate consumer credit markets to limit the effects of this credit expansion in creating overindebtedness. The phrase 'responsible lending' has become part of our vocabulary, as discussed in many of these papers.

Insolvency law remains an important focus of the materials. Insolvency procedures are a way to treat overindebtedness, to ameliorate some of the adverse consequences for debtors. Part 3 of the book contains articles discussing the effects of overindebtedness on insolvency filing rates and changes in insolvency procedures in many countries. Part 4 focuses on repayment plans, which is the only available insolvency procedure in many countries and in others has become an important alternative to discharge-focused insolvency procedures.

## I. CHANGING CONSUMER CREDIT MARKETS

After a long period of prosperity and steady economic growth, the western hemisphere experienced in 2007 unmistakable signs of economic trouble. The seriousness of the crisis was first manifested to the general public by the crisis of the US housing market. The globalization of the credit markets suggests that the repercussions of the housing loan crisis will be felt all over the world.

Both Gregory Squires and Christopher L Peterson provide background to this crisis. Gregory Squires examines how the disparities in levels of income and property have been increasing and analyzes the impact of this development on the US credit market. Squires notes that all subprime lending is not necessarily predatory, but patterns of predatory lending can be found in this market. Squires identifies several characteristics of predatory lending, which all point in the same direction: the poor pay more.

Developments in the home mortgage market are explained by Christopher L Peterson in his comparative article. Home mortgage lending was until recently

<sup>1</sup> Two of the earlier meetings were also organized as part of a Law and Society Association conference held in Europe. The first was in Glasgow in 1996, and the papers were published as a special issue of *The Journal of Consumer Policy* (vol 20, pp 133–287), edited by Niemi, Kiesiläinen and Ramsay. The second meeting was held in Budapest in 2001, and the papers were included in Niemi, Kiesiläinen, Ramsay and Whitford (eds), *Consumer Bankruptcy in Global Perspective* (Oxford, Hart Publishing, 2003).

considered as the most secure form of credit, for both debtors and creditors. The market has changed as underwriting practices have relaxed, facilitated greatly by the growth of a secondary market for bundled mortgage loans. It seems, however, that the risks involved with the expansion of credit and reaching new groups of debtors have not been understood by the regulators nor anticipated by the markets. Comparatively, the markets in Germany and Japan seem to be so much behind in the development of new securitization instruments that a similar crisis as in the US is likely to be avoided.

The expansion of credit has taken different and perhaps more anticipated forms in other parts of the world. Several articles in this book illustrate the growth of the consumer credit market, its consequences to the consumers and the reactions of the regulators in countries such as Brazil, Japan, Korea, South Africa, Australia, Great Britain and Germany. Brazil provides a telling example. While the level of poverty has decreased over the last decade, outstanding credit by individuals and households has increased eight-fold and the number of credit cards is now almost four times as high as in 2000. Claudia Lima Marques and Antonio Benjamin report an increase in the debt problems experienced by the lower middle class that has gained access to credit in the 'credit explosion' during the last five years.

Debt problems are a recurrent topic in the media. Iain Ramsay takes up the picture of debtors that is painted by the media in his discussion of overindebtedness in the United Kingdom. Some of the terminology he describes is mainstream consumer credit and overindebtedness usage, like 'credit crisis' and 'irresponsible or feckless borrowing', but the more imaginative metaphors he has found, like 'credit binges' and 'wannabe WAGs', can be used to draw attention to the way debtors are commonly described as deviant, aberrant and 'the other'. Ramsay also explores whether overindebtedness should be understood as a pathology of affluence, concluding that it is both a pathology of affluence and poverty in an affluent society.

## II. CONSUMER CREDIT REGULATION

After the turn of the millennium the regulation of consumer credit has been under serious policy discussions at national and regional levels in many parts of the world. These discussions are often framed along two regulation strategies: the liberalization of the credit market and the empowerment of the consumer, who is assumed to follow the rational actor model in her decision making; and the regulation of both the procedure for granting of the consumer credit and the content of the resulting contracts, with the goal of ensuring fair and secure credit contracts that protect consumers. These contrasts suggest an initial distinction between 'neo-liberal' and 'social market' approaches to regulation of consumer credit, with the UK and US within the former model and countries such as Germany representing the other. Udo Reifner argues that a neo-liberal

approach favors extensive disclosures to consumers, and protection against unfair surprise in contracts. It relies primarily on the market to police credit provision but recognizes the need for responsible lending and borrowing; financial literacy is intended to achieve the latter goal. Extensive consumer credit reporting is viewed as a central part of the institutional framework of the market. Accessible bankruptcy procedures provide a 'fresh start' for consumers so that they can re-enter the credit economy. The World Bank has adopted the broad lines of this approach in its development of 'best practices' in consumer financial protection.<sup>2</sup>

In contrast the 'social' model is based on the image of the 'hasty and needy consumer, forced into contractual relations by social circumstances he cannot control'. Social consumer protection in credit markets includes 'usury ceilings, capped default interest rates, protection against early termination and discharge, with warnings and information on debt'.<sup>3</sup> Reifner also argues that consumer credit law provides a potential relational model of consumer law which recognizes the need to provide opportunities for contractual adjustment to unforeseen changes such as loss of employment. The Chapters in this Part explore the above distinctions in regulatory approaches and assumptions as they unfold in contemporary national and regional regulation.

In discourses on overindebtedness the aim of prevention is often mentioned as a goal of policies that would restrict lender behavior. Besides the national policies, which have emphasized prevention for a long time, the Council of Europe has taken an important initiative to promote a common approach to overindebtedness. The recommendation by the Council of Ministers of 2007 takes a broad approach to the prevention of debt problems. Johanna Niemi takes prevention of debt problems as the starting point in her article, which is based on a preliminary survey of national laws on enforcement, credit registration and debt adjustment laws of the European countries. The Chapter discusses the possibilities of prevention through the use of credit registration and use of default data, financial education and protection of debtors in the enforcement procedures. While promoting all these, she concludes that prevention can not replace rehabilitative procedures in a credit society.

Udo Reifner, a scholar and long-time proponent of consumer rights, approaches consumer credit in his article from a broad ethical perspective. Together with consumer protection organizations he has developed ethical principles for responsible credit. These principles are in the form of soft law, giving general guidelines for responsible credit.

<sup>2</sup> World Bank (2008), *Finance for All: Policies and Pitfalls in Extending Access* ch 3. See the World Bank 'Good Practices for Consumer Protection and Financial Literacy in Europe and Central Asia: A Diagnostic Tool', August 2008, Consultative Draft. For an example of the World Bank approach to credit in emerging economies see A Kumar, *Access to Financial Services in Brazil* (Washington DC, World Bank, 2005).

<sup>3</sup> U Reifner (2007). 'Renting a Slave—European Contract Law in the Credit Society' in T Wilhelmsson, E Paunio and A Pohjolainen (eds), *Private Law and the Many Cultures of Europe*, (The Hague, Kluwer Law International, 2007), p 326.

The EU is committed to the creation of an integrated capital and credit market. There is also concern about overindebtedness.<sup>4</sup> The Consumer Credit Directive (CCD) of the European Union, adopted in 2008, is primarily a measure aimed at market integration. However, it contained in an early draft a strong 'responsible lending' requirement referring to the responsibility of the lender to consult relevant databases on the creditworthiness of the consumer before extending a credit and to ensure that credit was suitable to the needs of the consumer. The proposal was watered down before the final CCD was accepted. There were also many other issues debated, such as the scope of disclosure obligations and the rights of withdrawal and early payment. The result was a compromise between the interests of the financial institutions and the consumer organizations on almost every point. Sefa Franken discusses in her article the political process around the directive with a focus on the influence of the interest groups. While the financial sector was organized and well represented in the consultations, the consumer side seems to have a weak representation and difficulties in forming its opinion. However, as Franken notes, the financial institutions are also a non-unitary group and their silence on some central issues may mean that there are differing opinions within the group. As Franken shows, a more open legislative process would be in the interest of all EU citizens.

Susan Block-Lieb, Richard L Wiener, Jason A Contone and Michale Holtje take as their starting point the economic model of the individual consumer as a rational actor. Disclosure regulation, strengthened in the US by recent amendments to the Truth in Lending Act, and in Britain by reform of the UK Consumer Credit Act 1974, presumes a rational actor in deciding what information must be provided by a lender. Drawing on the work of behavioral economists, Block-Lieb et al present the results of a simulated empirical experiment, suggesting that the emotional value of disclosure on debtors is more significant than the effects of greater understanding of contract terms resulting from the enhanced disclosure.

Nations have reacted to debt problems in different ways, as several Chapters of this book indicate. The increase in debt problems in South Africa brought into daylight a credit market that was divided along racial and social lines. Until recently regulation basically reached only the 'upmarket' for white middle-class debtors. Michelle Kelly-Louw's article takes up the problems of debtors in the basically unregulated small-loans market, in which usury has flourished. The new consumer credit law is an ambitious attempt to regulate those loans, and includes both interest rate caps and a concept of reckless lending. Courts have the power to suspend the effect of offending credit agreements.

Souichirou Kozuka and Luke Nottage examine the growth and regulation of Japanese consumer credit, including a recently enacted responsible lending requirement, against the background of traditional justifications for regulation of

<sup>4</sup> The EU has initiated projects to develop a common definition of overindebtedness and to study financial exclusion. See EU Commission, *Towards a Common Operational European Definition of Overindebtedness*, DG Employment, Social Affairs and Equal Opportunities (2008).

the economy in Japan. They argue that contemporary regulation does not fit with traditional cultural explanations about the relationship of law to the economy in Japan. After considering several theories of Japanese political economy, including elite management and public choice, as well as normative theories drawn from neo-classical and behavioral economics, they conclude that reforms may represent an increasing pluralism and perhaps populism in Japanese politics.

### III. CONSUMER OVERINDEBTEDNESS AND INSOLVENCIES

The increasing debt problems of households have led lawmakers all over the world to seek new solutions and, thus, insolvency procedures for consumers have become more common in different parts of the world. Consumer bankruptcy or debt adjustment schemes, leading to partial or total relief of outstanding debt, have been the traditional answer to overwhelming debt problems in Anglo-Saxon jurisdictions. These schemes have also become increasingly common in European states (see Niemi; Kilborn; Backert et al) as well as in the industrialized Asian countries (see Oh; Kozuka and Nottage).

In all insolvency systems a key question is why debtors file. The Chapter by Ronald Mann, who earlier conducted an extensive comparative study of the variation in levels of consumer credit in different countries, compares the filing rates in several jurisdictions with a view to explaining what factors impact the different bankruptcy per capita rates in these jurisdictions. His main finding is that economic reasons are most important. Debtors in the US file consumer bankruptcy more often than in the other countries he studied (Canada, UK and Japan), not because they have a lax attitude to repayment of debts, but because they have more debt. The economic explanation does not exclude legal and cultural influences on filing behavior, however. Canadians, according to Mann, seem to have a lower threshold of filing for bankruptcy when they are overindebted than debtors in comparable countries. Mann argues that one explanation is the easy accessibility of bankruptcy in Canada, with low up-front payments and the lack of an effective requirement for a judicial determination of need for bankruptcy.

The issue of who are the debtors at risk of becoming overindebted or who have already become so are taken up by Catarina Frade and Claudia Lopes, Wolfram Backert et al and Johannes Doll. Frade and Lopes frame the issue about the households with the highest risk of becoming overindebted in a new way in their article with the concept of 'financial stress'. They want to understand how overall economic variables affect how households experience financial stress across the European countries. Interestingly, they find that the prosperity of the country, as measured by GNP, the availability of credit to households and the relatively even income distribution all diminish the financial stress experienced by the non-poor households in Europe.

Wolfram Backert, Ditmar Brock, Götz Lechner and Katja Maischatz report on a study of debtors who have filed for relief under German consumer insolvency

procedure. Their findings confirm the results of earlier studies that unemployment, family breakdown and loss of financial overview are the most common factors behind the overindebtedness, followed by business failure. Their study also offers support to Mann's thesis that easy accessibility of the insolvency procedure increases filing rates. A reform that made it possible to defer payment of the filing fee seems to have accelerated the rise in consumer insolvencies in Germany.

Some groups of consumers are more vulnerable to changes than others. One group that is often pointed to as most prone to debt problems are the young. Johannes Doll points out in his article that the elderly are also vulnerable to overindebtedness. In Brazil the possibility of assigning future pension payments for the payment of debt made the elderly an attractive group for the lenders and exposed them to overindebtedness in an unprecedented way.

Jason Kilborn, who looks at the European consumer insolvency systems with American eyes, distinguishes in his article about continental European countries two trends in insolvency procedures over the last 10 years. First, cumbersome accessibility criteria have been relaxed and the procedures simplified, at least to some degree. Second, there are indications that access to discharge has been made easier and special barriers abolished for debtors who have no or very little payment capacity. Kilborn agrees with Mann in advocating simplified procedures for these cases, called NINA (no income, no assets) or LILA (little income, little assets).

### IV. REPAYMENT PLANS

In the past comparative research on consumer bankruptcy has emphasized the availability of a discharge of unpaid debt, whether access to the discharge is conditioned upon repayment of some of the debt, and the institutional settings of bankruptcy procedures. Today most countries sponsor repayment plans, with or without a discharge option upon conclusion, and even common law countries that traditionally have emphasized nearly unconditional access to a discharge procedure increasingly emphasize repayment plans as an alternative. It is appropriate that scholars now look at the details of repayment plans and this Part contains several papers that do so.

All repayment plans are designed to yield some partial repayment to creditors. Some plans also offer the debtor a discharge and a financial 'fresh' start after payment of some debt. Some plans have the further objective of 'rehabilitating' the debtor, through education, social assistance or other means, with the aim of enhancing his or her future ability to cope responsibly with credit. This multiplicity of goals is balanced in different ways in different national jurisdictions, and that complicates the evaluation of repayment plans. For example, if there is not an alternative of straight bankruptcy in the jurisdiction, discharge achieved through a repayment plan can probably be judged a success. But if

unconditional, or straight, discharge is an alternative to a repayment plan, success is more difficult to define. Repayment might be considered a success for creditors, but it may not be the best course from the debtor's perspective if a discharge could be obtained more quickly and at lower cost by a different procedure.

Jean Braucher discusses in her article the methodology of measurement and evaluation of success with payment plans, drawing on empirical evidence from the US, Australia and Europe. An obvious measure of success would be the completion rate of confirmed plans. This, however, is not easily measured because it requires a long-term follow-up. Repayment plans typically take three or more years after filing before they are concluded. Many studies give reason to suspect that a considerable portion of plans fail. Especially in those circumstances, straight discharge might be considered a more successful option; it may provide creditors less repayment but it does provide the debtor some debt relief and at least a partial fresh start. Further, many payment plan schemes incur high administrative or legal costs, which are borne by the debtors, creditors and the taxpayers in different mix, and that has to be considered in evaluating repayment plans, especially in jurisdictions with a straight bankruptcy alternative.

The other Chapters in this Part of the book take up country examples of repayment plans. The backgrounds and contexts of these countries are different. The Australian repayment plans have been introduced in a bankruptcy system that has historically allowed immediate discharge but has had cost barriers and punitive effects for individual bankrupts. As John Duns and Rosalind Mason report, new debt agreement schemes with a repayment plan have been popular and the debtors have succeeded relatively well. However, Jean Braucher is more cautious, reminding us that the completion rates of the plans have not yet been followed long enough and that the goal of rehabilitation might have been reached in some cases more efficiently through a bankruptcy scheme.

After Korea experienced an explosion of consumer lending, followed by a realization that many of the debts could not be repaid as due by debtors, the Korean consumer insolvency law developed from a no-discharge bankruptcy law to a system that offers debtors several options. Soeogun Oh compares a workout program created by a covenant among the most important financial institutions in 2002, and a judicial rehabilitation process adopted in 2004. The workouts have come to be gradually outnumbered by the rehabilitations, which give a possibility to a more radical reduction of debts through a three- or five-year plan instead of an eight-year plan as in the workouts. Unlike the judicial rehabilitation process, however, the workouts also give protection to guarantors and to some extent against secured creditors, and consequently some debtors quite rationally still gravitate to the workout procedure.

England and Wales has now developed a variety of repayment alternatives for debtors which, when fully implemented, will provide a potentially complex array of public and private options to a debtor. These include: straight bankruptcy with the possibility of income repayments over a period not exceeding

three years; a reduced fee debt relief order—effectively bankruptcy—which will be available to low-income debtors with no assets and debts of under £15,000; an administration order for individuals with debts under £15,000 which promises the possibility of a write-off of debt after five years for those individuals successfully maintaining repayments; individual voluntary arrangements permitting debt composition and repayments normally over five years; private debt management plans usually without composition but with the possibility that the government may authorize certain private plans to write off debts. This complexity is partly a result of a lack of overall planning and competing departmental responsibilities. Government policy seems to support partial repayment rather than 'straight' bankruptcy as the central mechanism for overindebted debtors although such a policy has never been presented to Parliament. Michael Green describes the evolution of the payment alternatives since the beginning of the century, highlighting the extent to which the development of the Individual Voluntary Arrangement (IVA)—now viewed as the primary consumer remedy for overindebtedness—was developed by entrepreneurial insolvency practitioners who adjusted an existing commercial device to the mass consumer market. He also draws attention to the need for regulation of this private market for debt resolution.

Finally, the Dutch consumer bankruptcy law, enacted in 1998, has the unique background of a system in which discharge and partial repayment were based on contractual agreements between a debtor and his or her creditors, with the debtor supported by municipal banks both in negotiations and through financial contributions. The old system also put a lot of emphasis on the rehabilitation by evaluating a debtor's problems and offering social services. As Nadja Jungmann and Nick Huls describe, one purpose of the new law was to facilitate such negotiations and make informal settlements more enticing for the creditors. In practice, however, the amicable old system has been partially replaced with a more standardized and bureaucratic judicial procedure, which creditors seem to prefer even though it probably offers lesser repayment than is achievable through resort to the older preferred procedure. Nonetheless, the emphasis on repayment and the socially minded financial institutions are still part of the Dutch culture, reminding the rest of the world that there is a need for social banking and responsible credit all over the world.

The financialization of contemporary life ensures that issues of the appropriate role of credit, the legitimacy of differing types of credit, and regulation of the ground rules and pathologies of consumer credit, will remain important. The Chapters in this book demonstrate that although there may be significant international pressures towards the adoption of neo-liberal approaches to regulation, there are competing voices and regulation rarely follows strictly a neo-liberal template. Different countries' regulation may reflect particular conjunctures of events, interest groups and ideology. This conclusion is of general interest to the international and comparative study of the regulation of consumer markets.