

## Chapter 4

# From Truth in Lending to Responsible Lending\*

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### Introduction

Consumer credit law is a paradigm for contemporary consumer law. Its provisions include information transparency, the right of the consumer to withdraw from a credit contract, the opportunity for adjustment in the light of changed circumstances, the control of unfair terms, and screening of lenders.<sup>1</sup> A combination of private and public regulation, consumer credit law mixes economic and social concerns: the former represented by the interest in a transparent, competitive market, the latter by a concern for the potentially adverse social consequences of over-indebtedness. The recent proposal for a new EU Directive on Consumer Credit is representative of this paradigm with its combination of proposals to increase competition in the credit market while at the same time addressing problems of over-indebtedness that might lead to ‘economic exclusion and costly action on the part of Member States’ social services’.<sup>2</sup> I discuss in this chapter the role of information obligations in consumer credit law as a technique for achieving a transparent and competitive credit market and also in addressing over-indebtedness – a phenomenon of current concern in a number of EU

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<sup>1</sup> Many of these provisions are found in the proposal for a new EU Directive on Consumer Credit (see *infra* n. 2) and they exist in a variety of manifestations in national legislation in both Europe and North America. For further analysis of the economic and social dimensions of consumer credit law see Ramsay (1995).

<sup>2</sup> See Proposal for a Directive of the European Parliament and of the Council on the Harmonization of the Laws, Regulations and Administrative Provisions of the Member States concerning Credit for Consumers (Brussels, COM (2002) 443 final 2002/0222 (COD) at para. 2.4.) My comments are based on the original draft proposal of the EU Commission. This has been substantially criticized by the European Parliament. See European Parliament, Committee on Legal Affairs and the Internal Market, Notice to Members 2/2004.

countries.<sup>3</sup> I proceed by describing and evaluating the experience of disclosure regulation in credit transactions, then probe its assumptions in the light of psychological findings on consumer decision making associated with behavioural economics. Given the limits on consumer decision making suggested by this approach I analyse the recent EU proposal of a responsible lending standard as a possible response to information deficits in the consumer credit market and outline the potential for economic irrationality on the part of lenders.

### **The Development and Experience of Credit Disclosure**

Required disclosures of information by credit suppliers were adopted by many countries in the late 1960s and 70s,<sup>4</sup> with the primary objective of achieving a more transparent, competitive market through the discipline of informed and confident consumers. Disclosures may be required at several stages in a consumer credit transaction: in advertising, before a contract is executed, in the contract document, and during performance or on default. A central aspect – truth in lending – is the pre-contractual disclosure of the cost of borrowing stated as a cash figure and as a standardized percentage rate – the APR (Annual Percentage Rate). Disclosure of the APR is intended to provide a low cost, reliable signal for individuals wishing to compare different credit products. If sufficient individuals search by using this signal then this will induce competition in the market and reduce price dispersions. In addition, it should facilitate new entrants to the credit market. In the absence of regulation lenders would be unlikely to voluntarily develop such a standard.<sup>5</sup> Standardized disclosures may prevent market discrimination by credit providers between marginal (active searchers) and infra-marginal consumers.<sup>6</sup> It is sometimes claimed that disclosure of the standardized APR and other terms will prevent consumers becoming over-indebted.<sup>7</sup> This is reflected in the warning function of truth in lending, alerting a consumer to particularly high costs of credit or the severe consequences, such as loss of a home,

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<sup>3</sup> See generally Leitão Marques and Frade (2003), Chapter 6 and Introduction 2-4. For the UK see DTI (2003a); DTI (2003b), Chapter 5. For France see Assemblée Nationale (2003), p. 5: ‘surendettement ... ce problème social grandissant’. For a recent study of over-indebtedness in the EU see OCR Macro (2001).

<sup>4</sup> For US history see Rubin (1991); see also Duggan (1986).

<sup>5</sup> See Beales, Craswell and Salop (1981), p. 523.

<sup>6</sup> The issue of market discrimination is raised as an important issue by Schwartz and Wilde (1979), p. 666.

<sup>7</sup> See National Commission on Consumer Finance (1972), p. 174; Crowther Committee (1971), para. 3.8.13. ‘[F]aced with the temptation to spend people need to be made fully aware of the limits of their own capacity to make repayments, the cost and availability of borrowing and the rules and regulations surrounding credit trading, so that they do not over-extend their financial resources by ill-informed and rash use of credit facilities’.

for a consumer who defaults on the agreement.<sup>8</sup> It also provides a standardized synopsis of credit terms for future reference by the consumer in the event of a dispute, and facilitates enforcement of regulatory legislation (such as interest rate ceilings).<sup>9</sup>

Several points stand out in assessing the experience of truth in lending. First, it is characterized by adaptation and experimentation. There has been adaptation over time to the growth of variable rate loans and open-ended credit such as credit cards. There has been experimentation with different forms of disclosure such as the 'wealth warning' on loans secured against a home,<sup>10</sup> the 'Schumer box' that provides a concise statement of credit card costs and fees on solicitations for credit,<sup>11</sup> disclosures by credit card companies of the length of time required to pay an unpaid balance if a consumer only pays the minimum balance on the credit card,<sup>12</sup> and the requirements of heightened disclosures to potentially vulnerable groups.<sup>13</sup> Lenders have also attempted to avoid regulation through techniques such as the development of leasing in the US, shifting advertising to unregulated forms,<sup>14</sup> or burying disclosures in fine print. Regulators respond by further regulation, for example, requiring that the APR be more prominent than any other interest rate disclosure and that in some solicitations it appear in 18-point type.<sup>15</sup> This detailed nature of disclosure regulation underlines its characteristic as a form of bureaucratic regulation, dependent on technical expertise and empirical knowledge where regulators write detailed rules<sup>16</sup> that are incorporated into the contracts of the private bureaucracies that dominate the market for consumer credit in many countries. The development of disclosure rules in credit markets epitomizes Bourgoignie and Trubek's description of consumer law as a 'continuous, flexible, and often particularistic form of activity more than a fixed body of rules'.<sup>17</sup> It is one example of the materialization and differentiation of modern contract law.

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<sup>8</sup> See, e.g., the UK Consumer Credit (Content of Quotations) and Consumer Credit (Advertisements) (Amendment) Regulations 1999, Statutory Instrument 2725 s.3.

<sup>9</sup> See Landers and Rohner (1979), pp. 740-741.

<sup>10</sup> See *supra* n.8.

<sup>11</sup> This box is named after Senator Charles Schumer who promoted this reform in the US Congress. See Regulation Z § 226.5a (2).

<sup>12</sup> In the US, California introduced legislation to this effect. See Cal Statutes 2001, adding California Civil Code s1478.13, at ch711. Although this legislation was subsequently held to be invalid under the Federal pre-emption doctrine the idea behind the legislation has become influential. For recent English proposals to introduce a similar requirement in the UK see DTI (2003b), para. 2.32.

<sup>13</sup> DTI (2003b), para. 2.15.

<sup>14</sup> See *Jenkins v. Lombard North Central PLC* [1994] 1 WLR 1468 (CA).

<sup>15</sup> This is required in solicitations for credit cards in the US so that individuals are not misled by a temporary initial rate. See Regulation Z § 226.5 (b)(1). A recent UK Select Committee proposes the introduction of a similar rule in the UK. See House of Commons Treasury Committee (2003), para. 36.

<sup>16</sup> Regulation Z and its appendices runs to approximately 200 pages.

<sup>17</sup> See Trubek (1987), p. 9.

Assessments of truth in lending have often pointed to its limitations.<sup>18</sup> Commentators have argued that it has provided benefits primarily to middle class consumers and not low-income consumers,<sup>19</sup> that consumers only have a vague idea of how to use the APR effectively, and may focus on monthly payments rather than the APR. Consequently it may have had only a modest effect on consumer shopping behaviour. Criticisms of the impact of truth in lending are sometimes based on fairly dated research from the 1970s, but recent research does suggest a continuing lack of awareness among significant numbers of consumers concerning the concept of an APR.<sup>20</sup> Although it is not necessary for individuals to understand the concept if it is a reliable signal of comparative credit costs, the APR may mislead unsophisticated consumers as to the actual money cost of credit.<sup>21</sup>

In truth, it is not easy to measure the impact over time of truth in lending and to distinguish it from other influences on consumer behaviour. Studies often focus on individual knowledge rather than actual behaviour. The impact of disclosure must be viewed in the context of a market where it is not necessary for all consumers to be informed for a market to behave competitively, although there may be potential problems where lenders can discriminate between active searchers and other consumers. Recent research indicates that consumers feel more confident because truth in lending signals that creditors' behaviour is being monitored.<sup>22</sup> Most research has investigated the impact of pre-contractual disclosures on shopping behaviour rather than assess the value of disclosures at a later stage of the transaction, such as in relation to default or disputes. It is probable that consumers may find detailed information on their rights and responsibilities valuable at this stage.

Credit grantors and enforcement agencies in the UK have criticized the complexity of certain aspects of truth in lending<sup>23</sup> and some jurisdictions have questioned the value of the APR as a useful disclosure in relation to open ended credit such as lines of credit<sup>24</sup>, but there is little broad support for the dismantling of disclosure regimes. Current reforms in the UK, EU, Canada and New Zealand represent consolidation, modernization and rationalization of existing disclosure

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<sup>18</sup> See, e.g., Rubin (1991); and see discussion in Ramsay (1989), pp. 329-333.

<sup>19</sup> See, e.g., Wilhelmsson (1997), p. 223; Howells and Wilhelmsson (2003), pp. 380-382.

<sup>20</sup> See MORI (2003) finding that 38 per cent of those interviewed did not know what the term APR stands for.

<sup>21</sup> An APR may give consumers a misleading sense of the actual money cost of credit leading them to assume that a short term loan with a higher APR is much more costly than the same loan amortized over a longer period of time.

<sup>22</sup> See Durkin (2002).

<sup>23</sup> See Office of Fair Trading (1994), p. 15. The recent White Paper on consumer credit reform in the UK proposes simplification of the advertising regulations. See DTI (2003b), p. 7. There was pressure to simplify the Truth in Lending Act in the US that resulted in the Truth in Lending Simplification and Reform Act 1980. This was in response to the growth of class actions by consumers based on violations of Truth in Lending Act provisions. See Rohner (1981)

<sup>24</sup> New Zealand has jettisoned the concept of the APR as a standardised measure of all credit costs. See Macpherson and McBride (2003).

law. A political economy of consumer credit regulation might suggest that the absence of pressure for radical reform is because disclosures have only a modest effect on business practices, may advantage larger financial institutions in terms of compliance costs, and are more widely acceptable than regulation of contract terms. Whatever the explanation, information disclosures are viewed currently as central to the development of a competitive credit market of informed consumers who are no longer confused by the increasing range and complexity of credit products available on the market. This approach is captured in the recent UK proposals on credit disclosure whose objectives are 'to enable consumers to compare products with confidence, make informed decisions and therefore drive competition between lenders'.<sup>25</sup>

### **Assumptions of Disclosure Regimes and the Contribution of Behavioural Economics**

Credit disclosure regimes have not generally been premised on systematic theorizing about the role of information in markets beyond the idea of the importance of transparency to the workings of consumer markets. Neo-classical economics assumes a rational consumer who searches for information until the costs of search exceeds the benefits and the literature on information failure has identified situations where the high costs of search may lead to significant consumer detriment. It has also drawn attention to the fact that it is not necessary for all consumers to be informed for a market to function competitively. If a significant number of so-called marginal (searching) consumers search then the market will respond and other consumers may benefit, assuming that suppliers are not able to discriminate between marginal and infra-marginal consumers. The neo-classical approach also underlines the potential costs and unintended consequences of regulation and exhibits a preference for information remedies (disclosures, cooling-off periods) over more intrusive regulation (as represented by bans on terms). This approach is similar to that adopted by the ECJ in *Cassis de Dijon*<sup>26</sup> where the court exhibited a preference for information remedies and placed the burden of proof on those who proposed more extensive regulation.

Neo-classical economics recognizes that consumers may not pay attention to information in contracts at the time of contracting through 'rational ignorance', a form of cost/benefit calculation that concludes that the information relates to a later event that may be unlikely to occur. However, behavioural economics has drawn attention to systematic deviations from the model of the rational utility maximizing individual in neo-classical accounts of economic behaviour.<sup>27</sup> Its findings have been applied to a variety of markets but they have particular salience to consumer

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<sup>25</sup> See DTI (2003b), para. 2.1.

<sup>26</sup> Case C-120/78 *REWE-Zentral-AG v. Bundesmonopolverwaltung für Branntwein* [1979] ECR 649.

<sup>27</sup> For a comprehensive survey see Hanson and Kysar (1999a); Sunstein (2000); Conlisk (1996).

credit markets where individuals generally do not rely on professional advice. The conclusion that many of these systematic irrationalities in consumer behaviour do not seem to be corrected through repeat purchasing behaviour underlines their significance to regulation of credit markets. There are a large number of propositions associated with behavioural economics and it is a burgeoning field of research. What follows is a brief list of some propositions relevant to consumer credit.

First, individuals make systematic errors in assessments of risk, over estimating risks that can be recalled easily, for example vivid incidents (plane crash) that are newsworthy, and underestimating those which are less vivid (the possibility of a stroke). Unemployment is a primary cause of debt default. If we assume that the potential loss of a job and its impact on credit commitments is not highly salient among the public then individuals may underestimate the probability of debt default. While it is true that there are many media stories about the perils of debt over-commitment, the high visibility of credit advertising that connects credit to the good things of life may tend to crowd out information on the potential for default. These intuitions are borne out by a recent survey of credit consumers by the National Consumer Council that concluded:

Most of our respondents suppressed the risks involved, and felt confident (possibly over-confident that) in their ability to stay out of trouble ... consumers were aware that unexpected events could seriously affect their ability to pay but felt that this was something that happens to others. Most felt losing their jobs, suffering a serious accident or illness were remote possibilities.<sup>28</sup>

This quotation reflects a second finding in behavioural economics, that individuals are overoptimistic and therefore more likely to filter out information on the potential risks of credit at the time of entering the credit transaction.

Individuals may not act rationally and make consistent decisions over time.<sup>29</sup> We have time-inconsistent preferences that affect our willingness to delay gratification. Experiments indicate that an individual faced with the choice of receiving \$100 in six years or \$200 in eight years will choose the latter alternative, whereas an individual faced with the choice between receiving \$100 now or \$200 in two years, will invariably take the \$100. Yet they are the same choice framed differently. This finding recognizes that we may be 'multiple selves' with a tension existing between the impulsive and the planner self. Individuals might wish to protect the planner self from the impulsive self by 'hands tying' strategies such as automatic transfers to savings accounts, joining diet clinics that prevent exit, making public statements that one is quitting smoking and so on.

There is also the concept of 'information overload'.<sup>30</sup> This refers to the idea that as the amount of information provided to a consumer increases, she will use decision-making strategies that are more prone to error. It may be desirable

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<sup>28</sup> National Consumer Council (2002), p. 4.

<sup>29</sup> See O'Donoghue and Rabin (1999); Loewenstein and Elster (1992).

<sup>30</sup> For a survey of the literature on information overload see Paredes (2003).

therefore to present less information. Finally, there is one of the most robust findings in the literature-the framing effect-illustrated above in relation to the decision whether to accept money now or later. Individuals make different decisions depending on how a choice is framed. For example, individuals are more averse to a choice framed as a loss than the same choice framed as forgoing a gain.

Economists have applied the concepts of behavioural economics to the market for credit cards where credit card companies make the bulk of their profits from individuals who carry an outstanding balance on their cards.<sup>31</sup> Lawrence Ausubel concludes that individuals' bounded rationality – as reflected in their underestimation of the extent of their future credit card borrowing – explains the supra-normal profits of credit card operations in the 1980s, notwithstanding the existence of a large number of credit card providers in the US market.<sup>32</sup> His central argument is that there are substantial numbers of overoptimistic consumers who do not intend at the outset to borrow on their cards but who subsequently do so. These consumers are unlikely to be interest rate sensitive since they do not intend to use the card as a borrowing mechanism.<sup>33</sup> In later research Ausubel argues that consumers do not act rationally in response to low interest introductory offers of credit, overrating the importance of the introductory rate as compared to its duration or the ensuing post introductory rate.<sup>34</sup> David Gross and Nicholas Souleles note potential irrationality in consumers' response to an increase in credit card limits. Contrary to conventional economic analysis the extra credit was not used solely by consumers who were close to their credit limit. Other consumers also increased significantly their use of credit card debt. Individuals borrowed on credit cards even though they had access to alternative, cheaper sources of credit such as low cost home equity debt and checking and savings accounts.<sup>35</sup> Further research by David Laibson, Andrea Repetto and Jeremy Tobacman<sup>36</sup> suggests that US consumers seem to exhibit contrasting selves: acting irrationally in borrowing at high interest rates on credit cards while at the same time patiently accumulating significant amounts of long terms assets such as pensions.

Credit card companies, as profit maximizers, seek to identify these systematic irrationalities in consumer behaviour, and regularly conduct 'experiments' on consumers to identify the most profitable selling techniques,<sup>37</sup> for example,

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<sup>31</sup> The following comments on credit cards draws on Ramsay (2003).

<sup>32</sup> Ausubel (1991).

<sup>33</sup> Ausubel's argument on this issue has been challenged by other writers. See Cargill and Wendell (1996); Brito and Hartley (1995); Zywicki (2000).

<sup>34</sup> See Ausubel (1999).

<sup>35</sup> See Gross and Souleles (2002), p. 180: 'Most puzzling of all, over 90 per cent of people with credit card debt have some very liquid assets in checking and savings accounts, which usually yield at most 1-2 per cent'.

<sup>36</sup> Laibson, Repetto and Tobacman (2001).

<sup>37</sup> For example the US credit card company Capital One continually experiments with fees or collection methods to understand how they affect different types of consumers. In 2000 it conducted 46,000 product, price, marketing and distribution channel and service tests. See 'Capital One: Fanaticism that Works' US Banker, August 2001, Vol. III, Issue 8, p. 24.

automatically raising credit card ceilings, offering payment ‘holidays’, or reducing the minimum payment rate (now two per cent of the outstanding balance in some cases). This is of course not different from the behaviour of many businesses selling goods to consumers. Businesses accumulate a large ‘private sociology’ of consumer behaviour as part of their attempt to influence consumer preferences.<sup>38</sup> Hanson and Kysar describe the many psychological techniques used by businesses to manipulate consumer preferences, coining the idea that there exists a distinctive market failure that they call ‘market manipulation’.<sup>39</sup> The particular danger for consumers in the case of credit is that the practices of credit card companies may increase the risk of over-indebtedness.

Researchers on insolvency in North America have shown that individuals faced with an adverse change of circumstance often use credit card borrowing as a substitute for the limits of public support systems and as a mechanism for maintaining a lifestyle.<sup>40</sup> Individuals expect that their problems will be temporary and some continue to borrow past a time when any rational individual would do so. Borrowing on a credit card is however very costly and in the event that the problem is not temporary an individual may become over-indebted. This behaviour seems to fit phenomena identified by behavioural economics, namely that individuals have a status quo bias, are averse to losses, and are overoptimistic. The willingness to incur the high costs of credit card debt may also reflect the fact that individuals seem to have difficulties in understanding the effects of interest compounding leading them to underestimate the costs of paying off the debt.

There are several points which may be drawn from the literature on behavioural economics. First, the findings raise questions about the objectives and efficacy of disclosure regulation. A policy of simply providing more information may be a policy of accidental wisdom. Policy makers have been intuitively aware of the limitations of consumer decision-making. The use of the APR as a signal reduces the potential for information overload. The introduction of the ‘Schumer box’ in credit card solicitations economizes on consumers’ attention at a time when a consumer will not be committed to a particular transaction and these disclosures may stimulate competition in the credit card market. This could serve as a model for credit advertising generally. ‘Wealth warnings’ in relation to home mortgages exploit loss aversion, although any effects may be counteracted by consumers’ tendency to minimize the risk of default. Targeted disclosures to groups with a statistically high chance of default seem a promising development. Behavioural economics suggests that policymakers, like advertisers and credit card companies, should design information remedies in the light of its insights about the importance of the framing effect, loss aversion and so on.

Second, it may be dangerous to over-generalize about the potential impact of information disclosures. Rather than making broad distinctions between middle income and low-income consumers we should recognize that all consumers suffer from bounded rationality. Historical studies of working class credit suggest a

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<sup>38</sup> I discuss this at greater length in Ramsay (1996), Chapter 3.

<sup>39</sup> See Hanson and Kysar (1999b).

<sup>40</sup> See, e.g., Sullivan, Warren and Westbrook (2000), p. 137.

relatively high degree of planning by working class consumers in relation to credit.<sup>41</sup> Over-indebtedness among lower income consumers may simply reflect a greater likelihood that they suffer from more insecure forms of employment and other cost barriers (e.g. travel costs) to searching for credit. The challenge is to extend the choices available to lower income consumers and education and information may be one part of a programme of 'positive welfare' that combines regulation, education and institutional alternatives.

Third, one might be sceptical of the effect of disclosures at the time of contracting on reducing subsequent problems of over-indebtedness. Many studies indicate that it is a change of circumstance after credit is granted that triggers over-indebtedness.<sup>42</sup> Even the existence of a general cooling-off period of 14 days, as outlined in the proposed EU Directive on Consumer Credit, may have a limited effect given the phenomenon of cognitive dissonance – namely that individuals justify to themselves *ex post* the choice that they have made rather than admit that the alternative choice not taken might have been a superior alternative. Casual empiricism might support this argument since the very extensive French disclosure and cooling-off provisions appear not to have prevented a growing problem of over-indebtedness in France.<sup>43</sup> The difficulties of countering over-optimism and mis-estimations of risk at the time of entering the contract point to the importance of disclosures at a later stage of the relationship. Information concerning over-indebtedness and an individual's rights and responsibilities might be more effective at this stage of the transaction. Thus warnings about the dangers of paying the minimum balance on a credit card might be triggered by minimum payments for a period of two months. Post-contractual disclosures that are made at a later stage of a credit transaction might be quite extensive. The concept of 'information overload' may be inapplicable here since a consumer will be very interested in information on her rights and responsibilities and less distracted by point of sale marketing.<sup>44</sup>

Fourth, behavioural economics raises issues in relation to autonomy and paternalism in regulation and the construction of consumer law as a form of interventionist regulation. In some recent writing on consumer protection in Europe a sharp contrast has been drawn between information rules that enhance autonomy and mandatory rules establishing the basic terms of consumer contracts that restrict consumer choice and represent paternalism. Stefan Grundmann, Wolfgang Kerber and Stephen Weatherill argue that information rules 'diverge fundamentally from traditional mandatory rules that fix the content of the contract... [T]hey are designed to enable party autonomy, they do not restrict the variety of products and contractual conditions available'.<sup>45</sup> However, the recognition of time-inconsistent preferences, risk mis-estimations, over-optimism,

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<sup>41</sup> See, e.g., Johnson (1985).

<sup>42</sup> See, e.g., Sullivan, Warren and Westbrook (2000); Kempson (2002); European Credit Research Institute (2003), p. 4.

<sup>43</sup> See Assemblée Nationale (2003).

<sup>44</sup> See further on post-contractual disclosures Whitford (1973), pp. 466-467.

<sup>45</sup> Grundmann, Kerber and Weatherill (2001), p. 3.

framing effects, and the potential limits on information disclosures in preventing subsequent default and over-indebtedness, suggest that mandatory rules on credit terms related to default might be justified in terms of preserving individual autonomy. The fear that credit default might substantially compromise an individual's autonomy has influenced both common law approaches to credit contracts<sup>46</sup> and US consumer bankruptcy law.<sup>47</sup> These laws may be justified as protecting the future freedom<sup>48</sup> or autonomy of the consumer.

We might draw from the discussion thus far that consumer preferences are fluid and malleable and that they may be formed by the framing of the decision making process. Consumers' preferences may be constructed in the process of decision making. Herbert Hart criticized John Stuart Mill's protests against paternalism as based on the characteristics of 'what a normal human being is like which does not correspond to the facts'. Mill endowed his 'normal human being' with 'too much of the psychology of a middle-aged man whose desires are relatively fixed, not liable to be artificially stimulated by external influences; who knows what he wants and what gives him satisfaction or happiness; and who pursues these things when he can'.<sup>49</sup> The resurgence of neo-liberalism in European policy making suggests that there is a danger in attributing to the consumer too much of the psychology of the middle aged [male] law professor or judge!

Finally, this discussion raises questions concerning the legal distinction between the average consumer and the vulnerable consumer that has been adopted in the case law of the ECJ. The 'average consumer who is reasonably well-informed and reasonably observant and circumspect'<sup>50</sup> evokes an image of consumer decision making quite different from that suggested by behavioural economics. The law has identified groups of consumers who may be particularly vulnerable and in need of protection<sup>51</sup> generally identified with poor consumers, immigrants and ethnic minorities, disabled and the unemployed, individuals with low educational attainment, and the elderly.<sup>52</sup> However, it is not only low-income consumers who may be manipulated in the credit marketplace, although the costs of irrationality are comparatively higher for these consumers. The 'reasonably circumspect' consumer is, of course, an ideal type rather than an empirical reality. However, one senses that there is a belief that the 'reasonable' consumer of the law has some connection with a scientific model of the rational consumer. However, the dissonance between the law's model and consumer decision making in

<sup>46</sup> See, e.g., in the common law *Horwood v. Millar's Timber and Trading Company* [1917] 1 K.B. 305.

<sup>47</sup> See *Local Loan Co. v. Hunt* [1934] 292 US 234.

<sup>48</sup> See Smith (1996).

<sup>49</sup> Hart (1963), pp. 32-33.

<sup>50</sup> *Gut Springenheide* C-210/96 [1998] ECR I-4567, para. 31.

<sup>51</sup> See *Buet and Educational Business Services (EBS) SARL v. Ministère Public* (Case C-382.87): [1989] ECR I-1235, para. 13.

<sup>52</sup> The UK Office of Fair Trading identified seven categories of vulnerable consumers: those on low income, the unemployed, those suffering long term illness or disability, those with low levels of educational attainment, members of ethnic minorities, older people and the young. Burden (1998).

everyday life, draws attention not only to the rival rationalities of the expert and the lay person but also to the ideological content of the ‘reasonably circumspect consumer’. Undoubtedly this construction of the consumer is useful to a market integrationist strategy in the EU, another example of how conceptions of the consumer are hitched to the star of other groups’ agendas,<sup>53</sup> but behavioural economics underlines the contested nature of images of the consumer in contemporary society.<sup>54</sup>

At this point let me add some caveats. I am not suggesting that consumer law and policy should adopt the prescriptions of behavioural economics *tout court*. Nor should the law relentlessly pursue a series of interventions to attempt to correct the biases identified by behavioural economics. There remains disagreement concerning the significance and implications of its findings. Nor am I attempting to deny the possibility of consumers making impulsive market purchases so that only ‘rational’ purchases would be permitted – a policy with clearly authoritarian overtones. Rather the ideas in behavioural economics may assist in the continuing process of understanding the scope and limits of disclosure regimes in addressing problems in markets such as consumer credit where there has been historically a perception that consumers may make costly mistakes that threaten their autonomy and may reduce overall social welfare.

### Responsible Lending as an Information Strategy

The proposed EU Directive on Consumer Credit would introduce a ‘responsible lending’ obligation for lenders. This would require a credit supplier to gather information on the likelihood of a consumer being able to repay a credit obligation both at the time of entering an agreement and on any amendment of the agreement. This requires checking information held by credit bureaux. To facilitate this process cross border access to databases must be provided on the same terms as the access provided to local creditors.<sup>55</sup> The creditor must also choose the most appropriate form of credit for a consumer given the financial situation of the consumer, weighing the advantages and disadvantages associated with the product proposed and the purpose of the credit.<sup>56</sup>

Given the limits of consumer decision-making, the concept of responsible lending may be justified as a response to the limits of information disclosure to consumers as a technique for avoiding over-indebtedness. Under the proposed EU Directive the objective of the responsible lending obligation is to lessen the risk of consumers ‘falling victim to disproportionate commitments that they are unable to meet, resulting in their economic exclusion and costly action on the part of Member States’ social services’. The premise of the proposals is that there are too

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<sup>53</sup> For an excellent historical discussion of this phenomenon see Hilton (2003).

<sup>54</sup> For different models of consumer behaviour see Wilhelmsson (1996), pp. 53-65; Kysar (2003).

<sup>55</sup> *Supra* n. 2: EU Directive proposal Arts. 8 and 9.

<sup>56</sup> *Ibid.* Art.6.

many individuals defaulting on their debts and that lenders do not have sufficient incentives to reduce this level to a socially acceptable level because the costs of increased screening outweigh the benefits<sup>57</sup>. One commentator suggests that a similar Swiss provision is aimed at protecting vulnerable consumers<sup>58</sup> and those unable to resist the aggressive advertising of credit card companies. The concept of responsible lending has antecedents in existing national legislation and case law in the EU and previous Commission reports.<sup>59</sup> In the US the concept of ‘improvident credit extension’ was proposed by Vern Countryman as a response to the perception that consumer finance companies were contributing to the ‘bankruptcy boom’ of the 1960s in the US. A credit extension was improvident ‘where it cannot reasonably be expected that the debtor can repay the debt according to the terms of the agreement under which the credit was extended in view of the circumstances of the debtor as known to the creditor and of such circumstances as would have been revealed to him upon reasonable inquiry prior to the credit extension’.<sup>60</sup>

There are already excellent analyses of the significance of responsible lending as a ‘needs oriented’ form of law<sup>61</sup> or as representing a more cooperative model of contract. I wish rather to analyse it in the context of information failures on the supply side of the consumer credit market. Credit suppliers may face information deficits in assessing credit risk. Economists identify the problem of adverse selection in relation to credit markets.<sup>62</sup> Adverse selection refers to the fact that suppliers have difficulty assessing important characteristics of borrowers such as their general willingness to repay, willingness to take risks which reduce probability of repayment, and willingness to repay debts in the event of difficulties. Absent reliable assessments of such traits suppliers may not be able to discriminate between high and low risk individuals. A lender who sets a fixed rate of interest will attract some higher risk individuals for whom the price is a bargain and low risk individuals for whom it is not. Increasing the interest rate to compensate for higher risk individuals may at a certain level attract larger numbers of high risks rather than good risks so that profits are reduced below the level that would be made at a lower interest rate. A lender will find it more profitable therefore to refuse to lend above a certain rate, resulting in credit being *rationed* rather than being offered at a higher rate. The market for credit does not clear, that is to say, there are presumably individuals willing to pay the high rate who do not get access to the market.

The economic literature on adverse selection and credit rationing was developed in relation to commercial lending markets. In consumer markets a major antidote to problems of adverse selection has been the development of credit scoring<sup>63</sup> – the application of standardized statistical prediction techniques to credit

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<sup>57</sup> See Stauder (2003).

<sup>58</sup> See Stauder (2003).

<sup>59</sup> See COM (1995) 117, pp. 52-53, cited in Howells and Wilhelmsson (1997), p. 203.

<sup>60</sup> See Countryman (1975), p. 23.

<sup>61</sup> See, e.g., Wilhelmsson (1990). See also Howells (1997), pp. 271-274.

<sup>62</sup> See Stiglitz and Weiss (1981).

<sup>63</sup> For an introduction to credit scoring see Thomas, Edelman and Crook (2002).

granting – and credit bureaux that provide information on consumers and credit scores. Although credit scoring was originally used to minimize defaults it is also used now to maximize profits so that pricing of a credit card will take into account differential levels of default as one factor in calculating profit from a particular portfolio of credit card users. Credit scoring has also facilitated risk based pricing in the credit card market where credit card companies differentiate more finely between customers in relation to the level of interest payable on outstanding balances.

The existence of information sharing through credit bureaux represents a potentially significant reputational sanction for borrowers.<sup>64</sup> However, the impact of this sanction may differ depending on the nature of the information held by a credit bureau. Within Europe there is a divide between those countries such as France where credit bureaux only include negative information and others such as the UK that include positive information on an individual's credit repayments. Jorge Padilla and Marco Pagano argue that a system of negative reporting that reports only payment delinquencies is likely to result in greater incentives on borrowers to repay than a system that includes additional positive information on an individual's credit balances and repayment history. In the latter system a borrower who knows that a financial institution will also release positive information may have a higher incentive to default since she knows that one default may be discounted by lenders who have access to other positive information on the credit file.<sup>65</sup> It is also possible that extensive information sharing may facilitate a deeper consumer credit market but not necessarily result in lower levels of indebtedness or even default. A research institute financed by the credit industry claims that 'countries with positive registries such as the UK, the US and Sweden...have high levels of indebtedness'.<sup>66</sup> The development of 'sub-prime' or 'non-status' credit markets in North America, where there are higher risks of default, were facilitated partly by sophisticated positive credit scoring systems. A negative information system might dampen the development of this form of market as well as preventing individuals with a history of negative information from 'graduating' into the mainstream consumer market. Finally, a negative information system may have an effect on competition in the credit market by reinforcing the informational dominance of banks. These comments suggest some ambiguity about the overall effects of more creditor information: greater competition that could create incentives to 'oversell', more democratization in access to credit but not necessarily a reduction in the level of default.

There is a tension between the thrust of the responsible lending standard and the development of credit scoring, particularly as practiced by credit card companies. The responsible lending standard envisages a more individualised lending process, perhaps based on a meeting with the borrower. Credit scoring however permits a lender to grant credit without ever meeting the borrower. There are some advantages in the latter process since it reduces the potential for

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<sup>64</sup> See discussion in Padilla and Pagano (1999).

<sup>65</sup> *Ibid.*

<sup>66</sup> European Credit Research Institute (2003), p. 5.

individual prejudice to affect a decision. However, critics of credit scoring argue that some credit scoring systems focus on a limited number of variables, in particular past payment history, and believe that additional information, such as income, should be taken into account.

It is also possible that lenders, like borrowers, may make irrational decisions. A potential failure on the supply side of the credit market is that of 'irrational exuberance'.<sup>67</sup> Lenders have on a number of occasions during the past thirty years exhibited irrational exuberance in lending (e.g. lending to third world countries). Credit scores do not (I believe) include data on the likelihood of the economy going into recession or an economic bubble bursting<sup>68</sup>. In a recent English report on over-indebtedness the credit risk department head of a major lender is quoted as stating in relation to the practice of automatically raising credit card limits that: 'You can't afford not to do it because all your competitors are doing it'.<sup>69</sup> Financial institutions may be under powerful short run pressures to generate profits, creating incentives to cut corners. When the bubble bursts it is the borrower who may suffer as firms cut back sharply on lending and take collection action in relation to increased delinquencies. Responsible lending could play a role here either in enforcing a collective 'hands tying' contract by lenders to restrain practices that might contribute to over-indebtedness or in stimulating credit scoring systems that are more sensitive to economic conditions that may affect repayment levels.<sup>70</sup>

If credit scoring has the potential to democratize access to credit then one benefit of the responsible lending standard is to focus attention on credit scoring systems and ensure greater transparency in their operation. Given the important role of credit in society there should be opportunity for democratic debate and accountability in relation to these technocratic systems that include and exclude consumers within the credit market and discipline individuals through 'credit ratings'.

Lenders may also lack good information about a borrower's circumstances at the time of a default by the borrower. An obligation of responsible lending could encourage greater attempts by lenders to understand the position of the debtor and reach an amicable settlement. Creditors currently make extensive use of collection agencies that are often uninterested in the reasons for default by the consumer and are only interested in the commission payable on collecting the debt. This creates incentives for aggressive and illegal behaviour by collectors. Contracting out collection permits lenders to divert any reputation sanction for draconian collection activities away from themselves and on to the agency. Reducing the ability to externalize this cost could generate more incentives to reach a settlement.

A further issue in relation to the responsible lending obligation is its impact on lower income credit markets such as rent-to-own stores (for example, 'Crazy George' in the UK), doorstep credit and other forms of 'sub-prime' or 'non-status lending'. Lenders in these markets do not necessarily check credit bureaux and, in

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<sup>67</sup> See Shiller (2001).

<sup>68</sup> See Avery, Calem and Canner (2004).

<sup>69</sup> Kempson (2002), p. 40.

<sup>70</sup> See Avery, Calem and Canner (2003).

any event, in England and the US are willing to lend to those with negative credit records. In these markets it is comparative information on relevant choices that may be of greatest use to a consumer. The real challenge for policy in this area is to increase the availability of normatively acceptable options for consumers.

A fundamental question in relation to responsible lending is the standard to be achieved. Presumably the goal is to reduce the level of over-indebtedness or debt default to a socially acceptable level. The most effective method of achieving this goal may be to establish a clear performance standard, in this case the socially acceptable level of default, and to sanction or tax those lenders that do not achieve this standard. This would leave credit companies free to adopt whatever method was most acceptable to achieve this objective. This would require greater transparency by lenders in the presentation of their delinquency and charge off rates. However, establishing an appropriate level of debt default in society assumes a social consensus on this issue, something that does not exist currently. It is possible that a responsible lending standard could stimulate discussion between stakeholders on methods to develop concrete guidelines for different consumer credit markets.

## **Conclusion**

Truth in lending and disclosure legislation are instrumental forms of law intended to change market behaviour. We are perhaps more modest now than in the 1970s about the capabilities of instrumental law. One message of this chapter might seem to be a re-iteration of the limits of the information paradigm as the primary focus of consumer regulation.<sup>71</sup> However, I have suggested a nuanced approach to disclosure legislation that focuses on when and how consumers make decisions and when they will find information useful. Significant substantive disclosures on consumer rights in contract documents may be justified where those rights are likely to be exercised at a later stage of the transaction when individuals will have a strong interest in knowing their legal position. Such disclosure might reduce the overall social costs of adjustment to changed circumstances. We should also not assume that lower-income consumers would not benefit from disclosures, although issues of literacy and education ought also to be addressed. Since disclosures are unlikely to have a significant impact on over-indebtedness, more systematic regulation of default and development of over-indebtedness policy are necessary as part of consumer credit law. Consumer bankruptcy law is an integral part of consumer credit law and the right to declare bankruptcy is a mandatory default rule of all credit contracts in many countries.

Information disclosure is intended to promote consumer autonomy and increase social welfare through competitive markets. The concept of autonomy is however a slippery concept. In one of the most thoughtful analyses of this concept Jon Elster concludes that 'I can offer no satisfactory definition of autonomy' and

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<sup>71</sup> See Howells and Wilhelmsson (2003), pp. 380-382.

that autonomy is best understood ‘as a residual, as what is left after we have eliminated the desires that have been shaped by one of the mechanisms on the short list for irrational preference formation’.<sup>72</sup> Other writers also point to the difficulties of specifying the conditions for an autonomous choice.<sup>73</sup> In this chapter I have outlined some of the difficulties posed by the literature of behavioural economics for developing conditions of autonomous choice by consumers in the credit market. It is certainly arguable that regulation of contractual terms and mandatory terms may increase consumer autonomy, defined as future freedom. It is potentially misleading to view these rules of consumer protection law as necessarily a limit on party autonomy. The ‘planner’ consumer may wish to protect herself from the ‘impulsive’ self in market decisions and the political process provides the opportunity for citizens to register this preference through regulation.

These points are not restricted to consumer credit law. There is much current interest in the concept of autonomy in contract law. Consumer protection is sometimes viewed as an interference with autonomy (or freedom of contract). However, both the concepts of autonomy and freedom of contract may be compatible with significant state intervention.<sup>74</sup> Cooling-off periods and prohibitions on unfair terms may be justified in terms of freedom from contract, protecting individuals’ freedom to contract and make autonomous choices.

Finally, the decline of the welfare state and social safety net in many countries means that consumer credit is increasingly used as a substitute for state support or to finance activities, such as education, that once was wholly financed by the state. Theorists describe an increasing individualization of risk in society where individuals are required to ‘write their own biographies’ under conditions of uncertainty.<sup>75</sup> This public role of credit and debt regulation is most advanced in the US where consumer bankruptcy provides a safety net for many individuals who have used credit as a substitute for state financing of health care and unemployment. This public dimension of credit suggests that values from the public sphere such as democratic accountability and security against unnecessary risks for consumers should be relevant to the development of consumer credit law.

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<sup>72</sup> See Elster (1983), p. 21.

<sup>73</sup> See Trebilcock (1993), p. 148.

<sup>74</sup> See Rakoff (2004).

<sup>75</sup> See, e.g., Beck (1992).

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