Consumer credit regulation as 'The third way'?

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In this article drawn from his Keynote Address to the Conference, Professor Ramsay advances 'a third way', a new framework for ideas in an era of globalisation, for credit policy and regulation.

1. Introduction

In many parts of the world, reforms have recently been introduced or are being proposed to consumer credit law (EU, UK, Switzerland, Canada, Australia, New Zealand, US, South Africa and Asia). These reforms take place against a background of substantial growth in consumer credit [1] and the international spread of consumer credit institutions, such as credit bureaux[2], and particular forms of credit, such as credit cards.[3] In the US, the FDIC claims that there has been a consumer lending revolution[4] over the past 20 years while Elizabeth Warren and Amelia Tyagi describe a 'debt explosion'[5]. Deregulation, securitisation, the application of sophisticated computer technology to develop predictive credit scores and risk-based pricing, and the spread of all-purpose credit cards, have all facilitated the democratisation of credit. Consumer credit is increasingly the driver of the economy. Credit is used to pay for services, for example education and health care that were once provided by the State. In developing countries without a welfare state, the increasing availability of credit may provide access to these

[1] For documentation of the rise in levels of consumer credit in Europe see European Credit Research Institute 'Consumer Credit in the European Union', ECRI Research Report No.1, February 2000, p. 24. There remain significant differences in the levels and types of credit within different countries in the EU. Germany and the UK have higher levels of consumer credit than France, Italy, Netherlands and Belgium. The report also notes that the growth in consumer credit has been slower in Continental Europe than in the Anglo-Saxon countries [UK, US]. For Australia, see Reserve Bank of Australia 'Financial Stability Review', September, 2004. For Canada, see 'Financial System Review', June 2004. For Asia, see *Asia-Pacific Consumer*, vols. 35 & 36, 2004.
[2] See M Miller (ed.), *Credit Reporting Systems and the International Economy*, MIT Press, Cambridge, Ma., 2003, noting at p. 34 that 'The credit reporting industry is growing worldwide, spurred by technological innovation and the liberalization of financial markets.' Almost half of private reporting agencies were established after 1989.
[3] G Ritzer, *Expressing America: A Critique of the Global Credit Card Society*, Pine Forge Press, Thousand Oaks, Ca., 1995.
[4] See Federal Deposit Insurance Corporation, 'Evaluating the Consumer Lending Revolution', September 2003: http://www.fdic.gov/bank/analytical/fyi/2003/091703fyi.html
[5] Elizabeth Warren & Amelia Warren Tyagi, *The Two-Income Trap: Why Middle-Class Mothers & Fathers are Going Broke*, Basic Books, New York, 2003, p. 129.

services[6]. Households are now more highly leveraged with debt so that any shock to household income may cause financial trouble. The limits on state unemployment payments, and the absence of substantial savings, mean that individuals often use credit cards as a substitute for income support, when they become unemployed or face other changes of life circumstances.[7] Over-indebtedness[8], its causes, consequences, prevention and regulation is being studied in many countries as are the associated issues of financial and social exclusion[9]. Finally, the growth of the alternative or sub-prime credit market has raised concerns about high priced credit and unfair and predatory market practices[10].

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[6] DTI South Africa, 'Making Credit Markets Work: a Policy Framework for Consumer Credit', 2004, p. 4 discussing the role of credit in paying for university and school fees.

[7] See Iain Ramsay, 'Consumer Credit Society and Consumer Bankruptcy: Reflections on Credit Cards and Bankruptcy in the Informational Economy' in Johanna Niemi-Kiesilainen, Iain Ramsay & William C. Whitford, *Consumer Bankruptcy in Global Perspective*, Hart, Oxford, 2003, p. 23.

[8] There are different methods of measuring 'over-indebtedness'. See for example the various reports on over-indebtedness in the UK that are reviewed in 'Are UK Households Over-Indebted?' Report prepared by Oxera (2004); see also Bank of England, 'Financial Stability Review' December 2004 and Merxe Tudela and Garry Young, "The distribution of unsecured debt in the UK:survey evidence" (2003) Quarterly Bulletin, Bank of England 423; Udo Reifner, Johanna Niemi-Kiesilainen & Nik Huls, 'Study of the Legislation relating to Consumer over-indebtedness in all European Union Member States', 2004. For Australia, see Reserve Bank of Australia, 'Financial Stability Review', op. cit. 'debt to disposable income, interest payments to disposable income, and house prices' at or near record high levels but it notes that 'the quality of credit card portfolios in Australia appears high relative to that in a number of other countries' and that there are 'low levels of financial stress in the Australian household sector'. For Canada, see 'Financial System Review', 2003 op. cit.. Many countries have had significant increases in the rate of personal insolvency during the past decade. See for example, R Mason & J Duns, 'Developments in Consumer Bankruptcy in Australia' in Niemi-Kiesilainen, Ramsay & Whitford (eds.) op. cit., Chapter 11.
Certain groups are more prone to over indebtedness. These include lower income groups and, in particular, young families setting up home, households with low and unstable incomes, and individual small business persons. Causes of overindebtedness include changes of circumstance such as unemployment of one partner in a relationship underlining the fact that two incomes are necessary in contemporary society, inadequate income being supplemented by credit, and overextension of credit. There is therefore both passive and active indebtedness. The consequences may be lost productivity, stress, marital tension, health-related problems, and economic and social exclusion. .The EU Directive frames its provisions on responsible lending as intended 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.' For the most recent amended proposal see Amended 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 Repealing Directives 87/102/EC and Modifying Directive 93/13/EC COM (2004) Final. See also South Africa: 'Over-indebtedness has a negative impact on families and has in some extreme cases even led to family suicides. Over-indebtedness further has an impact upon the workplace, can lead to de-motivation, absenteeism and even a propensity to commit theft.' 'Making Credit Markets Work: A Policy Framework for Consumer Credit', DTI South Africa, 2004.

[9] See for example, UK Financial Services Authority, 'In or Out: Financial Exclusion a Literature and Research Review', 2000; James F. Devlin, "A Detailed Study of Financial Exclusion in the UK" 28 *Journal of Consumer Policy* 75 (2005); Australia and New Zealand Banking Group Limited (ANZ),2004 , A Report on Financial Exclusion in Australia, pp 2-4.

[10] This refers to forms of credit marketed to individuals with poor credit histories, or no credit histories, for example, immigrants. There has always been an alternative credit market but during the 1990s there has been a growth in this market in several countries. Reasons for the development of the sub-prime market are discussed in I Ramsay, 'The Alternative Consumer Credit Market and Financial Sector: Regulatory Issues and Approaches', 2001, 35, *C.B.L.J.*, 325–401; J Caskey, *Fringe Banking: Check Cashing Outlets, Pawn*

The internationalisation of sub-prime lending is reflected in the purchase of Household International, a sub-prime lender, by HSBC, which wishes to use the acquisition as a method of introducing the Household model of lending in the 80 countries where the bank has a presence.[11]

Against this background it is clear that regulation of contemporary consumer credit raises significant issues of economic and social policy for both developed and developing countries, and the internationalisation of consumer credit should stimulate reflection on the most effective forms of regulation of consumer credit.

The current policy debates in the UK and the EU in relation to proposed consumer credit reform reveal contrasting views about the role of market regulation, and the effectiveness of different techniques—such as interest rate ceilings—in consumer protection. In terms of underlying values some writers draw a distinction between individual and social consumer protection.[12] In the former, regulation is primarily through information disclosures and some control on unfair terms in credit contracts. The latter social consumer credit model has been defined to include interest rate ceilings, lender liability for irresponsible lending, controls on termination and default interest and restrictions on recovering debt collection costs from consumers..[13] Udo Reifner draws a

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Shops and the Poor (1994); R Swagler, J Burton, JK Lewis, 'The Alternative Financial Sector: An Overview, 7 Advancing the Consumer Interest', and in relation to high cost home equity financing see Kathleen Engel & Patricia McCoy, 'A Tale of Three Markets: The Law and Economics of Predatory Lending', 80, *Texas Law Review*, 1255. Examples of sub-prime lending include payday loans, the rent to own sector, debt consolidation loans and high cost home equity financing, title pawns, sub-prime credit cards, pawnbrokers, cash converters. For a recent description of the US alternative financial market, see Michael Barr, 'Banking the Poor', 21 *Yale Journal on Regulation*, 2004, p. 121.For Australia, see for example, Ministerial Council on Consumer Affairs, 'Fringe Credit Providers', Discussion Paper, August 2003 ; T. Wilson, 'The Inadequacy of the current regulatory response to payday lending' (2004) 32 *Australian Business Law review* 159. In the UK there have been several reports on sub-prime lending. See for example, Office of Fair Trading, 'Debt Consolidation', 2004; C Whyley & S Brooker, 'Home Credit', National Consumer Council, 2004; N Dominy & E Kempson, *Payday Advances and their Customers* (2003): S. Collard & E. Kempson, *Affordable Credit: The Way Forward* (2005),.
Predatory lending is a term adopted in the US to refer to practices such as refinancing and consolidating loans where the lender takes out security on the home of the borrower without being concerned about adequacy of income to repay; misselling of credit insurance in association with the credit [this involves for example, high premiums, insurance based on principal rather than declining balance and restrictions on paying out]; and continual refinancing of loans into longer loans where the consumer pays a lower monthly rate. This may result in 'Churning' where continual refinancing results in no reduction of the capital outstanding. A recent study by the OFT in the UK of debt consolidation raised concerns about some of these practices in the UK.

[11] See 'HSBC's Killer Move', *The Banker*, 6 October, 2003. The article notes that one of the reasons for the purchase was as a spearhead into new countries. The Chairman of HSBC notes that over the next 30 years, 50 per cent of the increase in world demand is forecast to come from emerging markets. 'Consumer finance will be the first step for many of the aspiring middle classes as they buy a car, then a house and then choose a credit card.'

[12] See Reifner et al., op. cit., p. 50.

[13] ibid., p. 222 where they outline the following 'social' elements: lender liability for irresponsible lending; flexible rate ceilings; acceleration clauses replaced by cancellation; limits on creditor's right to cancel for default; consumers in default should have time to readapt their credit and debt obligations to their actual situation; if debtor pays arrears then should have right to reinstate the agreement; capping of default rates;

contrast between the liberal model of the 'responsible consumer' for whom an information model of consumer protection is the primary policy and the social model that is based on the 'presumption of the hasty and needy consumer, forced into contractual relations by social circumstances he cannot control; someone lacking in concentration and in need of protection. According to this approach, it is the duty of the State to protect consumers by controlling the market.'[14]

Debates over the relative role of these approaches are often couched in terms of the values of autonomy versus paternalism and the appropriate role of legal rules in playing a redistributive role in the market. Some argue that there is no role for redistributive rules in consumer credit transactions because they are futile and regressive.[15] Redistribution should be achieved through the tax and transfer system. Only those measures justified by information failures should be adopted. Others have pointed out that all ground rules of a market have a distributive effect and that redistributive rules may on balance be an effective policy.[16]

I suggest that a 'Third Way' approach might advance analysis beyond the existing terms of this debate. The Third Way is intended as 'a framework of ideas for an era of globalisation'.[17] This framework recognises the market as a central institution and attempts to empower individuals to make responsible choices within the market at the same time as forging a social policy that recognises the limits of the state as a redistributive state but attempts to achieve social policy goals through a wide variety of techniques. Markets are within this approach embedded in society and 'markets can't … function without a social and ethical framework.'[18] Anthony Giddens suggests the idea of 'positive welfare' as a guide for social policy where all facets of a problem are addressed through a mix of educational, regulatory and material components that go beyond traditional tax and income transfer programs.
Thus we should recognise the centrality of the credit market and the need to empower consumers while also attempting to achieve goals such as affordable and accessible credit, effective sanctions against fraudulent and unfair practices, and addressing the causes and consequences of over indebtedness through a variety of policy measures that range from the educational and preventive to regulation and facilitating wider choice. Consumer credit is a potentially dangerous product and regulation may be justified to protect against the risks associated with it; this will also have the effect of stimulating confidence in the use of consumer credit.[19] The concept of risk spreading is well recognized in credit law. In addition, the avoidance of social exclusion is an important

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payments after default should be compounded to the capital first; linked credit contracts need special protection; and variable rates should be linked to objective market rates.

[14] ibid., p. 51.

[15] See David Cayne and Michael Trebilcock, 'Market Considerations in the Formulation of Consumer Protection Policy (1973) 23 *University of Toronto Law Journal* 396.

[16] See discussion of these issues in Iain Ramsay, 'Consumer Credit Law, Distributive Justice and the Welfare State' 1995 *Oxford Journal of Legal Studies* 15 177 at 181-189.

[17] See W Grant, *Economic Policy in Britain*, 2002, p. 229.

[18] A Giddens, *The Third Way and its Critics*, Polity Press, Oxford, 2000, p. 33.

[19] Examples of important risk allocation rules in credit are the bright line rules that limit consumers' liability for lost and stolen cards and the connected lender liability doctrine.

objective. This is a broader concept than poverty that includes not merely a lack of income but the inability to participate fully in the life of the community. Writers on consumption indicate that consumers define themselves as excluded if they do not have easy access to mainstream outlets for acquiring goods. A similar argument might be made in relation to methods of financing these purchases. Inability to access affordable credit from mainstream providers may create a sense of economic and cultural exclusion.[20]

Two illustrations of the Third Way approach are provided by the issues raised by payday loans, a form of sub-prime lending, and regulation of over-indebtedness.. In both cases a multifaceted approach is necessary that includes regulation, incentives for competition and the development of institutional alternatives. Payday loan markets may exhibit forms of monopolistic competition. In addition, mainstream lenders such as banks may be unwilling to enter these markets because they do not have experience in these markets, do not believe that they are profitable, or are concerned about the impact on their reputation. There may be a 'stigma' barrier to entry. Consumers may perceive that there are high switching costs. They may not be aware that they could access the prime market, and lenders in sub-prime markets cultivate borrowers through 'fictive friendships'. Consumers may suffer from bounded rationality in underestimating the extent to which they will need to 'rollover' a payday loan because they are unable to repay the initial loan. Consumers in these markets may be less likely to complain to third parties about unfair practices than more affluent consumers in relation to their credit suppliers. This finding is substantiated by statistics on resort to third party dispute handlers such as banking ombudsmen or small claims courts. There will also be less sustained media coverage of sub-prime markets and since media coverage and complaints are a surrogate form of political demand, there may be less continuing monitoring of the sub-prime market, with sporadic reactions to scandals reported by the media.

The potential policies that might be adopted here include the following :
(1) Introducing disclosure policies that address the particular information needs of consumers in this market.
(2) Reducing switching costs by facilitating credit reporting that empowers consumers to switch from the sub-prime to the mainstream market.
(3) Regulating prices through interest rate ceilings established at a rate significantly above the competitive rate for that market that are designed to be a proxy for overreaching behaviour in the market.
(4) Facilitating competition and entry by more reputable lenders.
(5) Experimenting with models of community reinvestment, the development of credit unions and partnerships between financial institutions and community or public interest groups. Credit unions might be encouraged to develop short term lending programmes.
(6) Targeted enforcement against unfair practices.
(7) Developing savings capacities among lower income consumers.

[20] See C. Williams & J. Windebank, 'The "Excluded Consumer": a Neglected Aspect of Social Exclusion' (2002) 30 *Policy and Politics* 501.

(8) Facilitating monitoring of market practices through the collection of regular data.

A second example is the recent overindebtedness strategy outlined by the UK government. It includes the following initiatives:

(1) The development of a national strategy for financial capability.
(2) Increases in affordable credit through development of credit unions.
(3) Iintroduction of a 'stakeholder suite' of financial products to promote asset savings
(4) Strengthening credit licensing;
(5) Attacking illegal money lending;
(6) Improved data sharing to underpin responsible lending decisions;
(7) Increased free available debt advice;
(8) Alternative dispute resolution (adr) for debt disputes;
(9) The improvement of insolvency with the introduction of a 'no income no asset' procedure
(10) Improvement in housing benefit and council tax benefit administration.[21]

Both these examples indicate that consumer credit policy must be viewed expansively as part of an attempt to achieve both efficiency and fairness in credit markets. This recognises the important public role of consumer credit in the economy and the fact that the achievement of both these goals contributes to economic citizenship and social cohesion.
The approach that I have outlined resonates with contemporary approaches to regulation that describe it as 'decentred', that is to say, that recognise that regulatory strategies should combine governmental and non-governmental actors and be involved in 'structuring and influencing market interactions rather than merely policing infractions of rules'.[22] For example, the overindebtedness strategy will require active cooperation of lenders and the voluntary sector..

In the balance of the paper I address two issues within a Third Way approach. Firstly I outline some of the difficulties in achieving the Third Way goal of the "empowered and responsible consumer" in the credit market. This involves assessing the implications of the extensive literature on behavioural economics for consumer credit regulation. I then turn to the supply side of the credit market and discuss the potential for the "responsibilization" of lenders in the credit market.

2. The contribution of behavioural economics to consumer credit regulation

During the past 25 years, there has developed a large literature at the intersection of psychology and economics that has drawn attention to patterned deviations by individuals

[21] See DTI/DWP *Tackling Over-Indebtedness* (20404) at 6.
[22] See Julia Black, 'Decentring Regulation: Understanding the Role of Regulation and Self-Regulation in a "Post-Regulatory" World', 54, *Current Legal Problems*, 2001, p. 103.

from the rationalistic assumptions of neo-classical economics. Behavioural economics draws on the insights of psychology and economics and focuses on issues of bounded rationality, bounded willpower and bounded self-interest.[23] Individuals have limited information processing capabilities, and use heuristics that may cause them to misestimate risks and create predictable biases in their decision making. Individuals are also poor statisticians, manifest a tension between an 'impulsive self' and a 'planner self' and do not always maximise their self-interest.

Behavioural economics is particularly relevant to consumer markets where individuals generally do not rely on professional advice. To the extent that these biases have been found to be repeated in experiments, even when individuals know the 'correct' solution, it suggests some limits on the role of market transactions as a learning process. Individual consumers, unlike businesses, are not driven out of the market if they make errors in market decisions. Moreover businesses through their market research identify and attempt to exploit these irrationalities in consumer behaviour.[24] Behavioural economics, by providing systematic explanations for consumer behaviour, may guide policy makers in designing 'debiasing' interventions[25].

The literature on behavioural economics is now voluminous and I merely outline some central findings in relation to consumer markets. Firstly, there are the findings of underestimation of risk and over-optimism. Individuals seem to make systematic errors in risk assessment overestimating certain risks that can be vividly recalled, for example, airplane accidents, and underestimating others, for example, the risk of contracting cancer.[26] Unemployment or reduced employment is a primary cause of debt problems, but is likely to be discounted by a consumer at the time of entering into a contract. Although it is true that there are stories in the media about over-indebtedness and unemployment they tend to be crowded out by marketing and advertising about the good life associated with credit. These intuitions seem to be supported by a recent UK National Consumer Council (NCC) study of consumers' attitudes to credit that found that consumers did underestimate this risk and thought that losing a job happened to other people.

Kommentti [HJB1]: AQ: What is NCC?

…most of our respondents suppressed the risks involved, and felt confident (possibly over –confident …) 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.[27]

Kommentti [JL2]: AQ: is this quote from Jolls?

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[23] For a recent overview with references to the large literature see C Jolls, 'Behavioural Economics' National Bureau for Economic Research, 2004. For a valuable application of behavioural economics to consumer bankruptcy see S Schwartz, 'Personal Bankruptcy Law: A Behavioral Perspective' in Johanna Niemi-Kiesilainen, Iain Ramsay & William C Whitford, op.cit., Chapter 3.

[24] See J Hanson & D Kysar, 'Taking Behavioralism Seriously: Some Evidence of Market Manipulation', 112, *Harvard Law Review*, 1999, pp. 1420 et seq.

[25] See C Jolls & C Sunstein, 'Debiasing through Law', Olin Working Paper, No. 225 September 2004.

[26] See discussion in W Kip Viscusi, *Fatal Tradeoffs: Public and Private Responsibilities for Risk*, OUP, 1992.

[27] See National Consumer Council *Credit-Choice or Chance* p.4 London: NCC (2002)

This quotation illustrates a second robust finding in behavioural economics: over-optimism. Jolls refers to more than 200 empirical studies of optimism bias.[28] For example most individuals assume that their chances of having an automobile accident are significantly lower than average. Students who take on substantial educational debt on the basis that this is the way to future success may be over-optimistic about their chances of success and underestimate future adverse contingencies.

The concept of bounded willpower recognises that we may have time inconsistent preferences, and illustrates the tension between the 'impulsive self' and the 'planner self'. We turn on the alarm meaning to arise at six o'clock the next morning so that we can have a healthy walk before breakfast, but when the alarm goes off, we turn it off and ignore it. Time inconsistency is reflected in experiments that indicate that individuals faced with the choice of receiving $100 in six years or $200 in eight years will often choose the latter alternative. However, the same choice framed as one of receiving $100 now or $200 in two years, results in the opposite tendency. Discount rates seem to decline sharply over time and to vary with the amount at stake. Individuals appear willing to pay high rates in relation to small amounts.[29] The tension between the impulsive and the planner self explains the development of 'pre-commitment' or 'hands-tying' strategies, such as automatic transfers to savings accounts, joining diet clinics that prevent exit and so on. Public pension plans were partly justified on this basis.

a) Applications of behavioural economics to consumer credit markets

i) Behavioural economics and credit cards

Behavioural economics has been used to analyse the structure of credit card pricing. Ausubel argues that the supra-normal profits of credit card companies in the United States in the 1980s reflected underestimation by consumers of their future borrowing on credit cards at the time of entering the contract. Over-optimistic consumers were not interest rate sensitive because they did not intend at the outset to borrow on the cards.[30] They were more sensitive to increases in annual fees than to increases in interest rates. He also applied the underestimation argument to argue that consumers do not act rationally

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[28] See Jolls op. cit. p. 7. An example of this in consumer credit is a recent study that indicates that 'consumers think that they can handle credit but other people can't'. Although individuals were in general happy with their credit card, they expressed concerns that others might not be able to resist the blandishments of credit card advertising or use credit prudently. 'Holders of bank type credit cards in 2000 believe that too much credit is available, that consumers are confused about some practices and that credit users have difficulty getting out of debt. Somewhat over half said that issuers should not be allowed to market cards to college students….negative views have not arisen from personal experience. Nine out of ten holders said that they are satisfied with their dealings with card companies, that their card companies treat them fairly…'I can handle credit cards but other people can't'. See T Durkin 'Consumers and Credit Disclosures: Credit Cards and Credit Insurance', Federal Reserve Bulletin, 2002, p. 201.

[29] See G Loewenstein & R Thaler, 'Intertemporal Choice' in R Thaler, '*The Winner's Curse*, Free Press, New York, 1992, Chapter 8.

[30] See L Ausubel, 'The failure of competition in the credit card market', 81 *American Economic Review*, 1991, p. 50. For a critique of Ausubel's analysis see T Cargill & J Wendell, 'Bank Credit Cards: Consumer Irrationality versus Market Forces', 30, *Journal of Consumer Affairs*, 1996, p. 373.

in relation to low interest introductory offers, overrating the importance of the introductory rate compared to the ensuing post-introductory rate.[31]

Later research by Bar-Gill[32] argues that underestimation and over-optimism have resulted in a structure of credit card pricing that overprices long-term contingencies, such as the need to borrow on a card or miss a payment and underprices non-contingent short-term prices, such as annual fees or transaction fees. While this structure does not necessarily result in excess profits — there may be intense competition over balance transfer rates, frequent flyer miles etc. — it does increase the costs of financial distress since the interest payments made when a consumer has suffered an income decrease will, given the decreasing marginal utility of money, outweigh any savings from the absence of an annual fee at the outset when the consumer has a higher income. To this must be added the social costs of financial distress and over-indebtedness. And this structure of pricing also results in cross-subsidisation of transactors by borrowers, a cross-subsidisation that may be regressive.[33]

Businesses that wish to compete successfully in the credit card market must exploit these behavioural biases, and credit card companies regularly conduct experiments to identify the most profitable technique, such as automatically raising credit card limits, offering payment 'holidays', or reducing the minimum repayment rate. Economists have documented the potential irrationality of consumers' response to these techniques. For example, contrary to conventional economic assumptions, it is not solely consumers who are close to their credit limit who increase their use of credit by responding to an automatic increase in their credit card limit.[34] Consumers seem to use credit cards to borrow, even though they have access to cheaper sources of credit, such as home equity debt and checking accounts.

There are several potential responses to these findings. Firstly, we may consider a 'debiasing intervention', namely disclosure regulation with the purpose of stimulating consumers to think about the potential biases in their preferences. Information could be provided of the dangers of paying the minimum balance. This could be targeted at individuals who were making minimum repayments and could be individualised. Bar-Gill suggests the following possibility: 'Debt increasing: at current repayment rate, it will take you 34 years to repay your debt and you will end up paying 300 per cent of the principal.'[35]

A second response could be to create default terms that retained consumer choice. For example, a minimum repayment level of ten per cent of the outstanding bill might be adopted that could be varied downwards at the express wish of the consumer. Another

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[31] L Ausubel, 'Adverse Selection in the Credit Card Market', Working Paper, University of Maryland, 1999.
[32] See O Bar-Gill, 'Seduction by Plastic', *Northwestern University Law Review*, 2004.
[33] See R Manning, *Credit Card Nation: The Consequences of America's Addiction to Credit*, Basic Books, New York, 2000, p. 18.
[34] See D Gross & N Souleles, 'Do Liquidity Constraints and Interest Rates Matter for Consumer Behaviour? Evidence from Credit Card Data', *Quarterly Journal of Economics*, 2002, p. 149.
[35] Bar-Gill, op. cit. p. 49.

default rule might be that a consumer would have to expressly request an increase in a credit limit under the card. This rule is adopted in Quebec, Canada.[36]

ii) Behavioural economics and payday loans

Why are individuals willing to pay extremely high rates of interest for small short-term loans? Because they have no reasonable choice is one response, but studies indicate that it is not only individuals who have 'no choice' who use payday loans. A repeated finding in behavioural economics is that individuals seem to be willing to pay high discount rates to obtain small sums of money immediately. In addition, the costs of waiting for a small sum may be processed mentally as foregone consumption rather than foregone interest so that given the power of immediate consumption an individual is willing to pay the high discount rate. Under-estimation and over-optimism may also be relevant. An individual who uses payday loans will have limited discretionary income or savings and may be over-optimistic about her ability to repay the loan on payday. She may underestimate the need to 'rollover' the loan or obtain another loan on payday. A primary criticism of payday lending is the existence of 'rollovers' where a consumer is unable to repay the loan on payday and so rolls it over into another loan. If this continues then the debtor is on a 'debt treadmill' where interest and other fees continue to rise but there is no decline in the principal balance.

These behavioural factors suggest the attractions and potential dangers of payday loans for at least some consumers.

b) **General implications of behavioural economics for consumer credit policy making**

The literature on behavioural economics has several implications for consumer policy making in relation to credit markets. Firstly, it poses practical questions about the design of disclosure regulation and when and how disclosures are made. We might be particularly sceptical about the effects of disclosure at the time of entering the contract in preventing subsequent overindebtedness. Secondly, it questions the sharp distinction between the rational and the vulnerable consumer — sometimes equated with class distinctions — that is often used in policy making.[37] All consumers are prone to these biases, although the consumer detriment suffered by lower income consumers from these biases may be higher. Thirdly it raises intriguing questions about the dichotomy between autonomy and paternalism in policy making. There is the tension between the planner self and the impulsive self and the recognition that an individual's preferences may be constructed in the actual process of choosing (for example depending on how a choice is framed). It poses the question whether regulation is necessarily an interference with the pre-determined preferences of the consumer.[38]

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[36] See Consumer Protection Act R.S.Q. Chapter P-40.1 s128.

[37] The definition of an average consumer adopted by the European Court of Justice and the recent EU Directive on Unfair Commercial Practices is a consumer 'who is reasonably well-informed and reasonably observant and circumspect'. See *Gut Springenheide* C-210/96 [1998] EDR 1-4567, para.31.

[38] See HLA Hart's criticism of John Stuart Mill's protests against paternalism as based on the characteristics of 'of what a normal human being is like which does not correspond to the facts' i.e. 'with too much of the psychology of a middle aged man whose desires are relatively fixed, not liable

The extent to which the state should overrule the impulsive self in favour of the planner is controversial but any a priori answer to this question might be rejected in favour of a more contextualised analysis of particular issues. Indeed, given the existence of behavioural biases, regulation might be justified to preserve autonomy. Present choices may create potential risks to an individual's future autonomy. It may therefore be desirable to ensure that an individual does not jeopardise her future freedom. Controls on seizure of goods, and the institution of consumer bankruptcy might be viewed in terms of enhancing autonomy. At common law, the law of penalties may be justified in this light.[39] This strategy attempts to insulate consumers from future severely detrimental consequences of their decision making that may also have external effects on others, such as family and employers.

Finally, the limits of consumers' ability to accurately foresee risks and potential trouble justify the need for rules and/or institutions that reduce the overall costs of adjustment to changed circumstances. These might include market-based schemes (insurance), rules on dispute settlement,[40] facilitation of low cost third party dispute settlement mechanisms, debt moratoria, and bankruptcy. The recognition of social *force majeure* as a reason for adjusting debts[41]--that is to say permitting individuals to reschedule debts when they have suffered an unforeseen setback such as unemployment—is partly a recognition of consumers' bounded rationality.

c) Behavioural economics and the future of credit disclosure policy

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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'. HLA Hart, *Law, Liberty and Morality*, Stanford University Press, Stanford, 1963, pp. 32–3.

[39] The extreme example is the case at common law of *Horwood v. Millar's Timber and Trading Company* [1917] 1 K.B. 305 where an individual became effectively shackled to his creditor under terms that the court held to be contrary to public policy. A further example is an overbroad security interest that places a consumer in a very difficult position on default. In *American Financial Services Association v. Federal Trade Commission* 767 F.2d 957 (1985), the Federal Court of Appeals stated 'Consumers threatened with the loss of their most basic possessions become desperate and peculiarly vulnerable to any suggested ways out…consumers may default on other debts or agree to enter refinancing agreements which may reduce …payments on a short term basis but at the cost of increasing the consumer's total long-term debt obligation.'
It was partly liberty reasons that underlay the development of individual bankruptcy as a fresh start in the US. Perhaps the most famous case associated with this drew on the prohibition on involuntary servitude in the US constitution,. *Local Loan Co. v. Hunt* [1934] 292 US 234.
[40] See for example, US Fair Credit Billing Act Pub. L. No. 93–495 15 USC 1666 and the UK Consumer Credit Bill provisions that will extend the jurisdiction of the Financial Services Ombudsman to consumer credit disputes.
[41] See T Wilhelmsson, '" Social Force Majeure" – A New Concept in Nordic Consumer Law' (1990) 13 *Journal of Consumer Policy* 1. This is recognised in the recent New Zealand *Credit Contracts and Consumer Finance Act* 2003 ss55-59 and also the proposed 'Enforcement Restriction Order' in England and Wales. See Department of Constitutional Affairs, 'A Choice of Paths: Better Options to Manage Over-Indebtedness and Multiple Debt', 2004, p. 19.

In this paper, I will not restate the history and objectives of credit disclosure legislation.[42] Commentators on both the left and the right have pointed to the limitations of the structure and content of credit disclosures.The highly detailed initial regimes were criticised for resulting in the regulatory "trilemma" of "circumvention, perversity and negative feedback" resulting in a pathology of ineffective regulation.[43] Some countries such as New Zealand now have simplified disclosure regimes. Canada is slightly more prescriptive and both the UK and the US retain very detailed disclosure regimes. Critics also argue that disclosures primarily benefit middle income consumers and not low income consumers; they often come too late to have an impact on shopping; consumers have only a vague idea of how to use the Annual Percentage Rate (APR) and often focus on monthly payments rather than the APR; and disclosures are too complex. In truth, it is not easy to measure the impact over time of truth in lending.[44] Current research suggests that the APR and the reputation of the lender are regarded by consumers as important factors in their choice of credit.[45]

Credit disclosure regimes have not generally been premised on systematic theorising about the role of information in markets beyond the idea of the importance of transparency to the workings of consumer markets [46] and the development of disclosure law has been characterised 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. Some countries no longer require an APR for open ended credit or credit cards.[47] There has been experimentation with different forms of disclosure including the following: 'wealth warnings' on loans secured against a home; the 'Schumer box' that provides a concise statement of credit card costs and fees on solicitations for credit;[48] disclosure of the time required to pay an unpaid balance if a consumer only pays the minimum balance

[42] I discuss this further in 'From Truth in Lending to Responsible Lending' in Geraint Howells, André Janssen & Reiner Schulze, *Information Rights and Obligations :A Challenge for Party Autonomy and Transactional Fairness*, (Ashgate, 2005), Chapter 4.

[43] For a critique of truth in lending in the US see E.L. Rubin, 'Legislative Methodology—Some Lessons from the Truth in Lending Act' 80 *Georgetown Law Journal* 233. The "trilemma" is taken from G. Teubner, ' Juridification of Social Spheres: A Comparative Analysis of the Areas of Labor, Antitrust and Social Welfare Law' (1987).

[44] Durkin argues that looking at consumer surveys over time 'it seems likely that disclosures required by Truth in Lending have had a favourable effect on the ready availability of information on credit transactions.' He reports a recent survey of credit card users that indicates that two-thirds of bank credit card holders believed that useful information on credit terms was either very or somewhat easy to obtain. See T Durkin, 'Consumers and Credit Disclosures: Credit Cards and Credit Insurance', Federal Reserve Bulletin, 201, 2002, p. 205.

[45] See MORI 'Consumer Awareness of Credit Issues', Research Study conducted for Department of Trade and Industry, 2003, p. 2. 'When considering which loan or credit card to apply for, the foremost factor in people's minds is the reputation of the lender (deemed important by over four out of five people.) Next comes –perhaps surprisingly given the relatively low awareness of this term — the APR (83 %), then any additional charges, simplicity and ease of the process.' Durkin notes that an opinion survey found that consumers rated annual fees and annual percentage rates as the top two terms. See Durkin, op.cit., p. 204.

[46] New Zealand reforms have drawn on some of the economic literature.

[47] Canada at the Federal level, New Zealand and Australia.

[48] This box is named after Senator Charles Schumer who promoted this reform in the US Congress. See Regulation Z § 226.5a (2).

on the credit card;[49] disclosure of the occurrence of negative amortisation,[50] the fact that interest continues to accrue on payment 'holidays' on loan repayments;[51] and heightened disclosures to potentially vulnerable groups along with the control of certain expressions in advertisements.[52]

We should continue this process of adaptation and experimentation. This involves continuing research on the impact of information regimes, and greater cross-referencing to the role of disclosure in related areas, such as financial services. The possibility of harnessing information technology to provide individualised disclosures at the point when consumers need the information should be investigated. Behavioural economics may also provide some guidance. Firstly, there is the well-known issue of information overload caused by bounded rationality that suggests that a policy of less, but better targeted, information may be used more effectively by consumers. This is reflected in the development of 'key financial information' documents and the 'Schumer Box' that provides a concise statement of credit card information at the time an individual is provided with an application. It would be dangerous however to use information overload as a general rationale for reducing information without analysis of when the disclosed information will be used by consumers. While individuals may absorb a limited amount of information at the point of purchase, they may be very attentive to information on contract terms, their rights, and sources of advice if trouble arises in relation to the credit contract. Extensive post-contractual information may be provided that might achieve the goal of ensuring that individuals are aware of their rights, and sources of advice. This information may assist consumers in achieving a negotiated rescheduling or settlement of an outstanding debt.

Secondly, experiments indicate that individuals respond differently to the same choice depending on how it is framed. They are more averse to a choice framed as a loss rather than the same choice framed as foregoing a gain. This seems to be related to the endowment effect — that we want to be paid more to give up an existing asset than we are willing to pay to acquire the asset. Disclosure warnings should therefore exploit this loss aversion. This already occurs with the 'wealth warnings' in relation to credit secured by home mortgages and in relation to high risk credit in the US.[53] Warnings in relation to high cost credit might be triggered by the use of certain terms. One could imagine standardised hazard signs, similar to those used in consumer safety regulation that could be attached to certain terms[54]. There is, however, a potential danger with warnings. If they are very salient then they may lead consumers to overreact. For example, an APR of

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[49] 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. In the UK banks have made a commitment to develop self-regulation on this issue.

[50] Canada Cost of Borrowing Regulations s 9.

[51] ibid., s15.

[52] UK: The Consumer Credit (Advertisements) Regulations 2004 s.8 (1) (c).

[53] Under amendments to the Truth in Lending regulations pursuant to the HOEPA (Home Equity Protection Act), certain high cost loans secured on the real property of the consumer are subject to heightened disclosures.

[54] Christopher Peterson proposes this and a number of other interesting disclosure techniques in *Taming the Sharks: Towards A Cure for the High Cost Credit Market* Akron, Akron University Press (20202).

200 per cent on a payday loan has a shock value that may deter an individual from using the product. That may indeed be one objective, but it may not be the best information for an individual who wishes to compare a payday loan with other alternatives. It is not clear whether an APR is meaningful for small short-term loans and more graphic information on the dangers of 'rollovers' could be a more effective disclosure.

Thirdly, given the optimism bias and the fact that individuals are poor statisticians, consumers are likely to respond to information that is personalised rather than general warnings or material on statistical risks. Information technology makes such an approach feasible and provides the possibility for targeting groups who may be most prone to default. An example is sub-prime credit cards that charge substantial late fees, and penalties for missed payments. Sub-prime consumers who may be subject to more sporadic income are more likely to pay these charges. This suggests that greater warnings to this group in relation to this fact could be communicated in billing statements.

The advantage of these 'debiasing interventions' is that they do not prevent individuals from entering a transaction but are intended to provoke an individual to reflect on her own preferences.

I recognise the limitations of disclosure policies. But we need to continue to develop these policies in a more nuanced manner that is based on empirical evidence as to the needs of individuals in different credit markets. Notwithstanding genuine issues around functional illiteracy in the population, we should not assume that lower income consumers could not benefit from more disclosures.

d) Behavioural economics and interest rate ceilings

Interest rate ceilings are the oldest form of regulation of credit. They exist in several European countries. France has a tiered system of ceilings depending on the nature of the credit, with rates set at one-third above the relevant market rate and Germany has a 'double the average' rule developed by the courts. Canada has a criminal interest rate of 60 per cent that was introduced in 1981 to address loan-sharking. In the US, several states have usury limitations in their small loans Acts.

Many economists argue that interest rate ceilings are counterproductive because they are futile (because creditors pass through increased costs to consumers) and have exclusionary effects, restricting choice to lower income individuals and driving them into illegal markets where they pay a "crime premium". A recent study for the UK Department of Trade and Industry (DTI) argues that these effects occur in Germany and France.[55] The persistence of interest rate ceilings has however stimulated economists to look more deeply at the rationales for them.

Kommentti [HJB3]: AQ: What is DTI?

One finding in behavioural economics is that individuals have bounded self-interest and care about fairness in market transactions. Individuals have a 'reference price' for transactions — the price at which a good is normally sold — and use this to criticise substantial departures from this price. For example, there has been substantial criticism of soccer clubs in the UK that raise ticket prices depending on the popularity of the visiting

[55] See Policis, 'The Effect of Interest Rate Controls in other Countries', DTI, 2004.

team. While this could be justified in purely neo-classical terms — increasing price in relation to demand — it is regarded as unfair. I suspect that many individuals might think it unfair that lower income individuals should pay a much higher price for credit and a political demand for interest rate ceilings may reflect this sense. It is possible that individuals who condemn high interest credit are using a 'reference price' for a mainstream rather than higher risk transaction. It is also possible however that those individuals would continue to believe that high-priced credit is unfair even if told the 'true' reference price, regarding high credit prices paid by lower income consumers as a regressive form of taxation.

It is useful to think through the objectives and impact of interest rate ceilings in consumer credit and it may be dangerous to overgeneralize about their effects. For example, a rate that is established substantially above the typical market rate for a particular sector may be one technique for attacking fraud and overreaching. Given the difficulties of policing low income markets, such a bright line rule would substantially reduce enforcement costs. Canada has special rules on the prices that may be set for income tax refunds[56] and some US states have established ceilings for payday loans. Interest rate ceilings should not be viewed as a significant method of redistribution or a long term solution to providing affordable and accessible credit to lower income consumers. But neither should reliance solely on "market forces". Ceilings may be one part of a larger set of policies designed to provide stability and security against unnecessary risk.

3. "Responsibilizing" the supply side of the credit market

An emerging concept in consumer credit regulation is that of "responsible lending". The objective is to prevent overly aggressive and unfair marketing practices and to reduce overindebtedness. In the UK, practices of credit card companies, such as automatic increases in credit limits, reducing minimum repayments, and sending unsolicited credit card cheques that do not explain clearly the consequences of using the cheques, have been criticised as irresponsible. In the US, Bills have been introduced in Congress that have focused on practices in the sub-prime lending market, such as lending against assets without regard to an individual's ability to repay. One proposal would combat predatory lending in relation to sub-prime mortgage markets[57] by prohibiting a loan being made where it resulted in total monthly payments that exceed 53 per cent of the consumer's gross monthly income. In South Africa, the concept of 'reckless credit' has been proposed that may be raised as a defence by an over-indebted consumer.[58] The EU has proposed a "suitability" model of responsible lending in the proposed EU Directive on Consumer Credit.

[56] See in Canada the Federal Tax Rebate Discounting Act and regulations, R.S.C. 1985 c.T–3.
[57] For current protection in relation to high cost sub-prime mortgages in the US see the Home Ownership and Equity Protection Act (HOEPA) 15 USC § 1639 which requires enhanced disclosures, and restricts loan "flipping", and balloon payments.
[58] See s114 (1) *Consumer Credit Bill* 2004 (for public comment).

Responsible lending is a convenient term for existing forms of regulation designed to address unfair credit practices. Thus the UK government uses the term to describe the reform of the extortionate credit bargain provisions of the *Consumer Credit Act* 1974 as well as in relation to the licensing regime and the development of trade association codes of practice.[59] However the concept of responsible lending represents more than a convenient new label. It may be viewed as part of the new thinking on regulation that explores the interaction of internal corporate culture, and economic, social and legal pressures. It may also be conceptualized as an aspect of the current focus on corporate social responsibility and corporate governance. Three developments in consumer credit are of interest here (a) creating a greater duty of care in lending through a suitability model of lending (b) varieties of self-regulation (c) the US Community Reinvestment Model.

Responsible lending needs to be placed in the context of contemporary lending practices, in particular, the increased use of sophisticated credit scoring and the international spread of credit bureaux. Credit suppliers face information deficits in assessing the willingness of borrowers to repay, and willingness to repay in the event of difficulties. Without reliable assessments of these characteristics, lenders may have difficulties in discriminating between high and low risks. During the last 20 years, economists have discussed the implications of these difficulties for credit markets and how borrowers and lenders might reduce these costs.[60] The existence of credit bureaux and credit scoring has permitted lenders to substantially reduce the information deficits that they face in the consumer credit market.[61] Credit reporting is now a worldwide phenomenon and Fair Isaac, one of the leaders in developing credit scores, offers a 'global credit score'.

The existence of information sharing through credit bureaux and the development of credit scoring facilitated the growth of credit cards, by reducing the costs and risks of managing large numbers of small accounts. Credit card companies use information from credit bureaux along with their own information on consumers to develop credit scoring regimes. They update their judgments on consumers using behavioural scorecards based on a consumer's use of credit and purchasing behaviour. This has led to behaviour-driven pricing and risk-based pricing where interest rates are more finely tuned to an individual's profile. Credit scoring was originally used to minimise defaults but it is also used now to maximise profits so that the pricing of a credit card will take into account predicted differential levels of delinquency and default as one factor in calculating profit from a particular portfolio of credit card users.

A recent development is the extension of credit reporting to assess the credit risk of individuals who have no or minimal credit history, such as recent immigrants, young

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[59] See DTI, 'Fair, Clear and Competitive: The Consumer Credit Market in the 21st Century', White Paper, Chapter 3 (2003).

[60] See for example, J Stiglitz & A Weiss, 'Credit Rationing in Markets with Imperfect Information', 71 *American Economic Review*, 1981, p. 393.

[61] The credit reporting industry, which includes both public and private credit reporting agencies, has grown substantially during the past twenty years. A World Bank survey noted that almost half of private reporting agencies were established after 1989. There is also increasing concentration so that in the US, the industry is dominated by three corporations. See Miller op.cit.

adults, or recently separated individuals. This will track payment history on products such as payday loans, deposit accounts and rent to own stores. The providers claim that this system will help 'businesses expand markets, reduce losses and make more financial services available to more people.'[62] Another innovation is the introduction of a system that collects information on housing rental payments, utility payments and other household payments that are intended to permit those with limited or no credit histories to develop credit ratings that will permit them to graduate to the housing market.[63]

There is increasing research on the impact of different types of information held by credit bureaux on the credit market. There is a divide between those countries, such as France and Australia where credit bureaux only include negative information and others such as the US and Canada, where positive information on account balances and credit limits are included. Economists argue that a system of negative reporting is likely to result in greater incentives on borrowers to repay than a system that includes additional positive information.[64] 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. It is possible therefore that extensive information sharing may facilitate a deeper consumer credit market that increases general indebtedness, but does not necessarily lead to a lower level of default. A negative information system might dampen the development of credit markets but prevent individuals with a history of only negative information on file from 'graduating' into the mainstream consumer market. A negative information system may have an effect on competition in the credit market by reinforcing the informational dominance of banks. The ability to access extensive credit bureaux information facilitated development of the so-called credit card banks, like MBNA or Capital One. These comments suggest some ambiguity about the overall effects of more creditor information: more competition, more democratisation in access to credit, but also increasing indebtedness and greater vulnerability of lower incomeborrowers to the effects of an economic recession.[65]

Given the crucial role of credit scoring and credit bureaux in credit markets there should be greater public dialogue concerning their performance. The issues of privacy and accuracy of data have been widely discussed. The central question is whether these manifestations of contemporary technology empower consumers. Like much technology there are both costs and benefits. The development of credit scoring in sub-prime markets could reduce the costs of making loans and therefore ought to reduce the price of these

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[62] http://www.fairisaac.com/Fairisaac/News/Press+Releases/Fair+Isaac+Launches+FICO+score+to+Underserved+Markets.htm

[63] See 'To build your credit, pay the rent', *Christian Science* Monitor, September 27, 2004: http://www.csmonitor.com/2004/0927/p16s01-wmgn.htm

[64] See T Jappelli & M Pagano, 'Information Sharing, Lending and Defaults: Cross-Country Evidence' Working Paper no.22, Centre for Studies in Economics and Finance, University of Salerno.

[65] See discussion of negative and positive scoring in J Barron & M Staten, 'The Value of Comprehensive Credit Reports: Lessons from the US Experience' in M Miller, op. cit., Chapter 8. See also A. C. Lyons, 'How Credit Access Has Changed Over Time for U.S. Households' 37 *Journal of Consumer Affairs* 231 (2005).Lyons notes that lower income groups have enjoyed increased access to credit between 1993-1998 but that this may also have 'encouraged households that have historically found it difficult to repay their debts to take on additional debt and live beyond their means'. Id. At 252.

products. This would also create a greater demand for these products and might result in mainstream institutions entering the market to offer alternative, cheaper products. It could also reduce the 'switching costs' that an individual faces in moving into the regular loan market. However, the development of behaviour-driven pricing may permit credit card companies to more effectively take advantage of behavioural biases in consumers.

Demands for transparency in credit scoring as a basis for dialogue may be related to broader themes in the study of business disclosures. John Braithwate and Peter Drahos in their text on Global Business Regulation[66] argue that transparency has become a global principle of regulation. Although there may not be support for the role of government in the redistribution of resources, there is strong support for the concept of informational egalitarianism and corporations are being pressured to disclose information on such issues as their employment practices in developing countries, or their human rights record.

Kommentti [JL4]: AQ: give reference here

(a) The "suitability of credit" Model in the European Directive

The reduction of over-indebtedness is the goal of the 'responsible lending' standard in the original EU Directive. This would require lenders to choose the most appropriate type and amount of credit for a consumer, given the financial situation of the consumer and weighing the advantages and disadvantages associated with the product proposed and the purpose of the credit.[67] This model may be analogised to the 'know your customer' requirement in the sale of financial services and the 'suitability' concept in securities law.[68] Swiss law attempts to concretise the standard of responsible lending by legislation that prohibits lenders from lending in situations where the loan would result in a consumer being left with less disposable income than the statutory exemption from wage attachment. [69]

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[66] J. Braithwaite and P. Drahos, *Global Business Regulation* Cambridge: Cambridge University Press 2000.

[67] See EU Amended Directive Art.6,. This concept has antecedents in existing national legislation in Belgium and the Netherlands.

[68] For an argument for the application of the 'suitability' model to the US sub-prime mortgage market see Kathleen Engel & Patricia McCoy 'A Tale of Three Markets: The Law and Economics of Predatory Lending', *Texas Law Review*, 2002, 1255.

[69] See articles 22–32 Loi Federale sur le crédit à la consommation. Under this law lenders must consult a database that will include positive and negative information before granting credit and must ensure that the borrower in taking on the credit will not be reduced below a minimum level of subsistence that is defined by reference to the exemption of income from seizure under debt enforcement law. This is a modest amount that is less than the recommendations of Swiss social agencies on minimum living requirements. The scope of the law is somewhat undercut because of special provisions in relation to credit cards and lines of credit. Credit card debt only has to be reported to the central database if it is over 3000 Swiss Francs. The credit limit on a card must be determined at the time of granting the credit taking into account credit bureaux information, and a 'summary' examination of the income and assets of the borrower (Art.30). A commentator on the law suggests that credit card companies and banks offering lines of credit will not be significantly affected by the legislation. The law does not apply to real estate mortgages. See

Variations on this model might include a requirement for lenders to provide consumers with their credit scores and the general range of credit prices that would be normally be available to someone with that credit score.[70] There is certainly a need for further analysis of the concept of responsible lending within the context of credit scoring. One view of responsible lending is that it envisages an individualised assessment of risk at a face to face meeting of a consumer with a creditor. However, credit scoring permits a credit card company to grant credit without ever meeting the consumer. The anonymous credit scoring system has the potential advantage of reducing costs and individual prejudices that may affect the decision.

(b) Varieties of self-regulation

Codes of practice and the work of Ombudsmen may be useful sites for the development of responsible lending norms. If the goal of responsible lending is to affect systematically market practices then the norms of responsible lending must be incorporated in everyday employee practices. This may require changing the structure of incentives for employees. For example, there are allegations that in certain sub-prime finance companies in the US, there was a structure of incentives within the organisation that led to unfair practices such as 'insurance packing' and 'churning'[71]. In the UK critics of bank lending practices have drawn attention to the role of employee incentives that result in inappropriate lending. The consumer credit industry is highly competitive. In this situation, there will always be a temptation to cut corners, to free ride on broad corporate or trade association statements of responsible lending, while not necessarily adhering to these at the lower levels of the organisation. A sales department that has to achieve certain performance targets may be tempted to oversell. The consequences of this overselling will be the responsibility of the collections department rather than sales. It is possible that lenders, like consumers, may be subject to irrationalities such as the

generally Bernd Stauder, '"Le prêt responsible": L'exemple de la nouvelle loi Suisse sur le crédit de la consommation.'

[70] See Peterson op.cit..

[71] See for example, 'Equity Predators: Stripping, Flipping and Packing Their Way to Profits', Hearings before the Special Committee on Aging United States Senate (105th Congress) (2d Session), (March 16, 1998). Statement of Jim Dough, Former Employee of a Predatory Lender, 'Finance companies require branch employees to make contact every three months with customers to prevent payoffs and up-sell to bigger loans. In my experience in the industry, flipping was a common practice. We were instructed and expected to flip as many loans as possible…Packing is taking insurance products –as many as you can-putting them on the loan and then trying to cover them up or gloss over them…[It] is shoving as much insurance onto the customer as possible without the customer's knowledge or without the customer's understanding…Because insurance sales are so important to the bottom line, finance companies require that their employees meet goals and quotas regarding insurance…My employers made it clear that I would not keep my job unless I fulfilled my insurance sales quotas…Finance companies also provide additional rewards for employees who meet or exceed their insurance sales quotas…Part of my bonus depended on whether my branch met its insurance sales quotas.'`

See also the settlement between the US Federal Reserve and Citigroup in May 2004 where Citigroup was alleged to have required co-applicant loans in order to increase joint insurance sales in contravention of the regulations under the Equal Credit Opportunity Act that prohibit requiring a signature of a spouse or other person on a credit instrument if the applicant qualifies based on their own creditworthiness.

'irrational exuberance' described by Robert Shiller.[72] It may not be easy to develop a collective 'hands-tying' practice within a highly competitive industry.

Kommentti [JL5]: AQ: give a reference?

Traditional forms of regulation such as bans on particular types of selling practices (for example in relation to single premium credit insurance) remain important and in several countries the extent to which a company has an effective compliance programme may be taken into account in determining the level of fines and sentencing for regulatory offences.

However it is also important to stimulate a culture of compliance and corporate social responsibility. This might be achieved by requiring companies to institutionalize self-regulation within a company and ensure that this self-regulation is effective. Christine Parker has outlined the requirements of effective self-regulation to include ensuring that compliance is part of everyone's job and the reward systems in the corporation are changed for both managers and employees to ensure that substantive and not merely formal compliance is assured. [73]. The Financial Services Authority in the UK in a pilot study of the policies and practices of six large retail investment sellers found that although firms recognised the importance of treating customers fairly in their policies the controls on the ground were not always consistent with this objective.[74] Parker suggests that a corporation should draw up a "Justice Plan" that would identify its obligations under the law and other standards that it wished to adopt and that this plan could be used by external groups to contest corporate action. This is an area that needs much greater work as Parker argues that 'the methodologies for evaluating corporate compliance management are critically under-developed at present'.

The example of Citigroup is instructive. In 2001 Citigroup took over the Associates Finance Company a company that operated in the sub-prime US market and that was subject to allegations of predatory lending. The takeover provided an opportunity for many public interest groups to raise questions about predatory lending and it became a public relations disaster for Citigroup. It ultimately settled cases brought by the FTC and the US Federal Reserve but was required to submit a plan that would ensure that its branches complied with all laws and regulations and its own policies and procedures, as well as developing an acceptable internal audit plan.[75] It had also agreed earlier to drop a number of controversial lending practices such as the sale of single premium credit insurance. But it continues to be subject to criticism by consumer groups in relation to its use of mandatory arbitration in its credit contracts. Public interest groups also raised the issue of predatory lending at its annual shareholder meeting in 2002. Research in the UK indicates that reputation is a significant factor in consumers' choice of credit provider. It may be important therefore to make information easily available to consumers on complaints against a particular institution and to ensure that parent companies are responsible for the reputation of subsidiaries. It is not uncommon for a mainstream

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[72] See R. Shiller, *Irrational Exuberance* Princeton: Princeton University Press 2000

[73] See C. Parker *The Open Corporation: Effective Self-Regulation and Democracy* (Cambridge: Cambridge University Press, 2002).

[74] See Financial Services Authority, *Annual Report* 2003-2004 p.26.

[75] See Board of Governors of the Federal Reserve System, In the Matter of Citigroup and Citifinancial Credit Company, Order to Cease and Desist and Order of Assessment of a Civil Money Penalty Issued Upon Consent 27 May 2004. See also the settlement between Household Finance and US State Attorney Generals.

financial institution to offer sub-prime products through wholly owned subsidiaries trading under a different name.

A model of co-regulation underlies some of the work of the The Financial Consumer Agency of Canada,[76] established in 2001, that has responsibility for enforcing the consumer credit provisions that apply to Federally regulated financial institutions. The agency also monitors any codes of conduct and "public commitments" that have been adopted by financial institutions in relation to consumers. Its compliance framework requires firms to have a compliance management system in place that reports on compliance to the Board of Directors. Firms must also refer complaints that they receive that are escalated beyond an initial level to the agency. It is too early to say whether this model of regulation that attempts to harness the internal bureaucracies of corporations will be successful.

(c) Community Re-Investment Model

Enacted in 1977 as a response to the practice of redlining the Community Reinvestment Act in the US requires that banks meet "the credit needs of its entire community, including low and moderate income neighbourhoods, consistent with the sound and safe operation" of a bank. Banks are evaluated on how they are meeting the credit needs of low and moderate income borrowers and neigborhoods and receive grades on the extent to which they lend and invest in these communities.
The Act gives institutions some discretion in how they achieve these goals. The sanction in the Act is that regulators consider CRA ratings in determining whether to permit a merger or expansion of a bank. The blocking of a proposed merger in 1989 probably focused the attention of bank executives on the effects of the Act. A further incentive was that some government agencies and states would only place their deposits with banks that have earned higher than satisfactory ratings. In addition, since 1990 the CRA ratings have been made public. Local community groups have standing to participate in CRA lender evaluations and since 1989 have been able to access data on the race and income of applicants for loans under the Home Mortgage Disclosure Act.
A review of the Act in 2001 concluded that that the Act had resulted in an expansion of home purchase loans to low and moderate income households.[77] It also stimulated banks to develop community based lending and investment schemes. The programme also resulted in some innovative forms of expanding community lending, for example, through the provision of financial education, matching funds for Individual Development Accounts, and donations of computers in lower income neighbourhoods, that might stimulate the use of internet banking.

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[76] For further information on this agency see the material at http://www.fcac-acfc.gc.ca/
[77] See Robert Litan et al US Department of the Treasury, The Community Reinvestment Act After Financial Modernization: A Final Report (2001) online at http://www.ustreas.gov/press/releases/reports/finalrpt.pdf

The Act has also created groups within banks that have developed knowledge of lower income credit markets and in some cases facilitated collaborative work with community groups. The review found that corporate culture played a role in whether an institution vigorously pursued an outstanding as opposed to a satisfactory rating on a CRA examination. In some institutions it was a source of pride to achieve an outstanding rating, for other firms the incentive was primarily to eliminate potential delays in expansion of the bank.

The CRA harnesses legal powers, reputational incentives and social pressures (through community activists) to achieve its objectives. It has undoubtedly promoted reflection on the role of banks in serving lower income consumers and may have helped to change cultural perceptions within banks of the profitability of lower income markets. It has the potential for achieving what Parker describes as "open self-regulation" that brings together management responsibility and the law and increases democratic social responsibility through accountability to external community groups; it may be a small step in deepening democracy.[78]

Conclusion

In this paper I have suggested that consumer credit regulation should be viewed broadly as part of economic and social policy and that successful achievement of the goals of consumer credit policy involves decentered as well as traditional forms of regulation. The policy questions should not be framed as simply a choice between information policies or contract regulation, autonomy and paternalism, efficiency and fairness. We should develop a more comprehensive set of policies that will harness both regulators and actors in civil society and that will be subject to empirical testing and democratic accountability. The importance of consumer credit in contemporary economies demands nothing less.

[78] See C. Parker, 'Is There a Reliable Way to Evaluate Organisational Compliance Programs?' (2002) at 2 and on deepening democracy see Archon Fung & Erik Olin Wright, 'Deepening Democracy: Innovations in Empowered Participatory Governance' 29 *Politics and Society* 5 (2001).