Financial Services, Financial Crisis and General European Contract Law

Failure and Challenges of Contracting

Edited by

Stefan Grundmann
Yeşim M. Atamer
List of Contributors

Elisa Alexandridou  Professor of Law, Law Faculty, Aristotelian University of Thessaloniki, Greece
Yeşim M. Atamer  Dr iur., LL.M. (Istanbul), Associate Professor of Civil Law and Comparative Civil Law at Istanbul Bilgi University
Olha O. Cherednichenko  Ph.D., LL.M., Senior Lecturer in Private Law at VU University Amsterdam, Centre for Law and Governance
Nicole Grmelová  Assistant Professor teaching EU Institutions and EU Law at the University of Economics, Prague and a PhD candidate at the Law Department of the Faculty of International Relations thereof.
Stefan Grundmann  Dr iur., Dr phil., LL.M. (Berkeley), Professor of German, European and International Private and Business Law, Humboldt-Universität Berlin
Brigitte Haar  Dr iur., LL.M. (Univ. Chicago), Professor of Private Law, German, European and International Business Law, Law and Finance and Comparative Law and member of the executive board of the House of Finance at the Goethe-University Frankfurt
Johannes Köndgen  Professor of Law, Rheinische Friedrich-Wilhelms-Universität Bonn, Faculty of Law and Economics
Marc Kruijthof  Dr iur., LL.M., Professor of Law, Ghent University Law School and University College Ghent, Faculty of Business Administration and Public Administration
Javier Lete  PhD, Senior Lecturer in Civil Law, University of Santiago de Compostela
List of Contributors

Rachael Mulheron  Professor, Department of Law, Queen Mary University of London
Karl Riesenhuber  Dr iur., (Potsdam), MCJ (Austin, Texas), Professor of Civil Law, German and European Commercial and Economic Law, Ruhr-Universität Bochum
Jules Stuyck  Dr iur., Katholieke Universiteit Leuven, Faculty of Law, Centre for European Economic Law, Professor of European Law and Consumer Law
Ünal Tekinalp  Dr iur., Emeritus Professor for Commercial, Corporate, Banking, Intellectual Property and European Law
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Duty of Responsible Lending: Should the European Union Take Action?

Yeşim M. Atamer*

I. INTRODUCTION

The credit sector plays an important role in the European Union (EU) economy. Loans to households (including consumer credit, loans for house purchase and other credit) in the Euro area were amounting to a total of 5,167.5 billion for 2010. 1 Obviously, this figure by itself does not imply that there is a problem. But, as of November 2009, consumer credit outstanding stood at 9.9% of the EU Gross Domestic Product (GDP) and was accounting for over 17% of household’s consumption expenditure. 2 This figure amounted to 36.6% in Cyprus, 36.7% in Poland, 36.8% in Spain and 22.1% in the United Kingdom (UK). As of 2007, outstanding residential mortgage lending in the Twenty-Seven EU

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1. <http://sdw.ecb.europa.eu/reports.do?node=100000143>. 641.8 billion of this sum consists of consumer credits, 3,706.8 billion of loans for house purchase and 818.9 billion of other loans.

2. DG Health and Consumer Protection, Establishment of a Benchmark on the Economic Impact of the CCD on the Functioning of the Internal Market in this Sector and on the Level of Consumer Protection, November 2009, see chart at 95.

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Member States represented over 50% of the EU GDP and outstanding consumer credit lending represented 7.7% of EU GDP. Analysis of Eurobarometer last published in 2006 shows that 13% of households across EU Member States have difficulties meeting credit and other household commitments.

This picture combined with the spill over effects of the subprime mortgage crisis, which was triggered by a dramatic rise in mortgage delinquencies in the US, obviously forced also the EU at least to rethink its position regarding overindebtedness caused by credit taking. In March 2009, the EU Commission has issued a Communication on ‘Driving European Recovery’, stating that in order ‘to deliver responsible and reliable financial markets for the future, the Commission will propose an ambitious new reform programme, with five key objectives’. One of those objectives is ‘to ensure that European investors, consumers and Small and Medium Enterprises (SMEs) can be confident about their savings, access to credit and their rights as concerns financial products, [and therefore] the Commission will come forward with... measures on responsible lending.’ Following this Communication the EU started a ‘Public Consultation on Responsible Lending and Borrowing in the EU’ in June 2009. The responses to this public consultation were published towards the end of November and are now being evaluated by the Commission. For the time being the measures to be taken have not been announced.

These policy initiatives from 2009 indicate that the EU will not leave it at the point where the Directive 2008/48 on Credit Agreements for Consumers has left it. This Directive, although put into force on 23 April 2008, that means, when the mortgage crisis was already at full speed, does not include any specific provision on responsible lending. This is especially striking given the fact that the Commission’s first draft of the Directive provided for such a duty. But from this draft to its October 2005 draft, many of the Directive’s key provisions have been eliminated.

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3. DG Internal Market and Services, Public Consultation on Responsible Lending and Borrowing in the EU, 4 Jun. 2009.
5. But also the Council of Europe urges in its Recommendation of 20 Jun. 2007 its forty-seven Member States to introduce legal solutions to debt problems providing the necessary measures and regulations to ensure responsible practices during all phases of the credit relationship including marketing of credit as well as the collection and use of credit data and other financial information. Cf. Art. 2(d) of the Recommendation CM/Rec (2007)8 of the Committee of Ministers to Member States on legal solutions to debt problems.
due to intense critique from stakeholders of the financial sector, Member States and also the European Parliament.11 Today Directive 2008/48 only speaks of an ‘obligation to assess the creditworthiness of the consumer’ (Article 8) and compels creditors to ‘provide adequate explanations to the consumer’ (Article 5(6)).12

II. IS THERE A PRACTICE OF IRRESPONSIBLE LENDING?

Before elaborating on the issue whether a duty of responsible lending should be introduced also in the EU, and if so in which form, it has to be ascertained if irresponsible or reckless lending to consumers is a phenomenon or not. Looking into literature on consumer lending, it seems, that some lending practices entail a special potential for market failure or consumer detriment. Three examples should be given here: the credit card system and the originate to distribute system, which are both in particular focused on in US literature, and the involvement of credit intermediaries in the lending process, which is a topic raised by the European Commission.

– Credit card system: As put forward by Ronald Mann, the successful credit card lender profits from borrowers who become financially distressed.13 It is the financially insecure customer who generates interest income, late fees or over limit penalties. For the credit card lender, profitability comes when the cardholder stops regularly paying the balance in full each month and starts to pay interest.14 Therefore, the incentive for responsible lending is pretty low.15 Even if the bank knows that its borrower is highly likely to

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12. But even these norms have a very restricted applicability given the fact that Directive 2008/48, like its forerunner 87/102/EEC, excludes credit agreements which are secured by a mortgage or by a right related to immovable property and also credit agreements, the purpose of which is to acquire or retain property rights in land or in an existing or projected building. In general, credit agreements involving a total amount of credit more than EUR 75,000 are also excluded. Although the White Paper on the Integration of EU Mortgage Credit Markets, COM(2007) 807 final, has stressed ‘the importance of good information, responsible lending and borrowing, and high quality advice for consumers in ensuring they purchase the best product for their needs’ the Commission has, until today, not initiated a measure on mortgage credits.


bankrupt and that the loan will be written off in whole or in part, he does not care, because he makes back his investment in penalty interest and fees relatively quickly regardless of the remaining principal balance. As long as card issuers can optimize default rates and externalize losses to other parties, increased delinquency rates will be welcomed.

– **Originate to distribute system of lending:** Another example of a moral hazard leading to irresponsible lending can be observed in the well-known subprime lending practice. Meanwhile there are research results, which show that the quality of loans in the US deteriorated for six consecutive years before the crisis, and that securitizers were, to some extent, aware of it. According to Demyanyk and Hemert the subprime market experienced in many respects a classic lending boom-bust scenario with rapid growth, loosening underwriting standards, deteriorating loan performance and decreasing risk premiums. Excessive liquidity led to the increase of lending volume but also to a parallel decrease of control standards, that is high loan-to-value loans and speculative lending. This development was backed up by an incentive structure, which helped spreading the credit (default) risk. By way of securitization the banks were given the chance to sell their loans in the secondary market. Their capital was only invested for a short period, in which the introductory ‘teaser’ interest rate was applicable and therefore the risk of defaulting was anyway very low. Once the loan was assigned the proceeds could be used to finance a new consumer. The secondary market in assignment of home mortgages has influenced the origination practices and underwriting standards. As the lending practice shifted from originate-to-hold to originate-to-distribute model, it began to interfere with the originating banks’ screening and monitoring incentives. The originate-to-distribute model of lending allowed them to benefit from the origination fees without bearing the credit risk of the borrowers.

This structure combined with the ‘bubble’ in housing prices, failure of the rating agencies to accurately appraise the risks of the subprime

17. Demyanyk and Hemert, n. 16 above, 32.
20. Peterson, n. 19 above, 32.
mortgage lending market, credit pricing features like brokerage fees dependent on the number and the amount of loans closed, or teaser pricing the disaster was inevitable.

– Involvement of credit intermediaries: A recent study of the EU Commission shows that credit intermediaries were involved in the conclusion of 41.5% of all residential mortgage contracts and 28.8% of consumer credit contracts between 2006 and 2007. The most common form of remuneration of intermediaries is either commission based, where the intermediary is paid for each contract he has brokered; or it is volume-based, where payment is defined as a percentage of the volume of credit agreed upon by the parties. As the Commission rightly puts it, both types of payment are prone to unscrupulous activity. There is no incentive for risk assessment because the intermediary can secure its entire profit margin already with the conclusion of the contract.

These examples show that, at least for some types of credits, there is a serious potential of irresponsible lending due to lack of incentives on the side of the lenders. As long as they are able to externalize the effects of default, they will not waste time and money on fulfilling the optimum underwriting standards. Therefore regulation seems to be justifiable whenever a comparable moral hazard exists.

III. IS THERE A PRACTICE OF IRRESPONSIBLE BORROWING?

However, it is not only this potential of reckless lending which produces a strong argument in favour of regulation. The second argument comes from the lessons of behavioural economics. By integrating psychology and economics and drawing on evidence from social psychology the behavioural economics theory has meanwhile shown the limits of the efficiency based rational choice theories – at least whenever problems of less sophisticated borrowers are addressed. The concept of the

23. Public Consultation on Responsible Lending and Borrowing in the EU, n. 3 above, 11.
25. Public Consultation on Responsible Lending and Borrowing in the EU, n. 3 above, 13–14.
27. Bar-Gill, n. 22 above, 1073, 1123 et seq.; Ulen, n. 26 above, 98, at 111 et seq. But cf. for a critical approach regarding the application of behavioural law and economics to consumer
wealth-maximizing *homo economicus*, who is rational, fully informed and able to choose, which is in his best interest, free of cognitive and other limitations is replaced by a consumer, who is far more than expected irrational, impulsive and lead by subjective opinions, gossips or fears. These features combined with financial illiteracy result mostly in unfavourable contracts. The key question here is obviously why people tend to borrow excessively rather than at optimum level, or choose a credit card with a higher interest rate even when there are ones with a lower rate offered in the market. The behavioural-economics theory explains the imperfect rationality of borrowers by referring to several factors.

– *Unrealistic optimism*: The optimism bias, as pointed out by cognitive studies and social psychology, entails that individuals tend to be over-optimistic about their future. Accordingly borrowers tend to be optimistic about their future income. They often misjudge the probability of losing a job, encountering an accident, illness or divorce, which might bring about financial hardship. Credit card users’ optimism manifests itself in the often wrong expectation to maintain a zero credit balance. Therefore they are insensitive regarding interest rates and do not compare offers in the market. The underestimation bias results in distorted competition and setting of credit card interest rates above marginal cost. Underestimation of future borrowing shifts the competition in the credit card market from the long-term price elements like interest rate to the short-term price elements like annual fees.


29. Blaurock, n. 11 above, 697, 710. However, the behavioural critique of the global financial crisis shows that not only consumers but also the finance sector itself encounters problems living up to the standards of the *homo economicus* given their focus on short-term profit and limited tendency to remedy their cognitive biases, cf. in detail E. Avgouleas, *The Mechanics and Regulation of Market Abuse, A Legal and Economic Analysis* (Oxford: Oxford University Press, 2005), 22 et seq.; Avgouleas, n. 18 above, 23, 34 et seq.


Myopia and self-control problems: Some borrowers are myopic, overvaluing the short-term benefits of a transaction at the expense of the future. This type of bias leads to the choice of loan contracts with escalating-payments given the fact that myopic borrowers place excessive weight on initial low payments and insufficient weight on future high payments. The low introductory interest rate (the teaser rate) is an example of product design that targets exactly consumers’ imperfect rationality in this regard.

Cumulative cost neglect: The effect of borrowing 5 times 200 in comparison to 1,000 at a time is not the same. Bounded rationality often stems from neglect of the cumulative effect of large numbers of relatively small borrowing choices, which especially causes over-indebtedness due to usage of credit cards.

Ignoring complexity: The imperfectly rational borrower deals with complexity mostly by disregarding it. He simplifies his decision problem, e.g., by ignoring insignificant price dimensions and taking mental shortcuts that often lead him astray.

Although the basic rule of a free market society, where people themselves have to judge what contributes to their material welfare, is certainly still valid, the insights of behavioural-economics force to rethink whether regulation against over-indebtedness is needed and if so in which form.

IV. IS REGULATION AGAINST OVER-INDEBTEDNESS NEEDED?

Any model of regulating consumer credit is based on a value judgment regarding the ‘debt culture’ of nowadays societies. On one edge credit is seen as a disciplinary force to modern society and the key to affluence, on the other it is the ‘folk devil’, which has to be tamed. The models range from the neo-liberal approaches with their laissez-faire policies to a Keynesian interventionist form of government policy. Without denying the primarily positive effect consumer

33. Bar-Gill, n. 22 above, 1073, 1120.
36. For a definition of over-indebtedness cf. DG Employment, Social Affairs and Equal Opportunities, Towards a Common Operational European Definition of Over-Indebtedness, February 2008, 5 et seq. and Hoffmann, n. 10 above, 262.
credits and credit cards have on economic development, findings of economic theory explaining why unfettered markets are not self-correcting and why regulation is needed cannot be disregarded. In the aftermath of the global economic crisis this seems to be true more than ever. If one function of the State is to maintain and foster a free market economy the other is to prevent all citizens from falling below a minimum welfare level. In case a contracting party persistently misconceives the consequences of a contract due to underestimation of future borrowing, and this cognitive defect is intentionally exploited by the other contracting party leading to risky and socially costly behaviour an intervention seems to be appropriate.

Regulation is needed here since the normative power of contractual consent is significantly and systematically weakened. The efficiency argument concluding that all voluntary contracts need to be enforced does not convince under such circumstances. The reason for this type of regulation is not only the protection of the individual and to restore contractual equilibrium. It is also the threat over-indebtedness poses to social welfare, which makes interference inevitable. Placing consumers at risk of financial distress increases the number of individuals who, instead of contributing to society, will be forced to rely on society for help.

Control of contract terms via the doctrine of unconscionability, immorality or duress, via unfairness in standard contract terms, anti-fraud or usury laws is common to many jurisdictions and helps to reprimand risky, socially costly
behaviour. But given the fact that bounded rationality frequently impairs consumers’ welfare due to wrong borrowing choices, it should be elaborated also on how to protect consumers best against their biases and how to hinder lenders exploiting those biases. That is, seeking for means of ex ante prevention of reckless credits being extended.

V. METHODS OF PREVENTING OVER-INDEBTEDNESS

Obviously, there is no single formula to solve such a multifaceted problem like over-indebtedness. Different types of government regulation may make sense in responding to these ills. But in the author’s view it is important to repeatedly challenge every possible method and to adjust strategy according to new insights:


– Financial counselling by a third-party: Mandated financial counselling can also be effective in overcoming cognitive deficits like the optimism bias or the ignorance in regard to complexity. Counselling can have different tasks like budget analysis and advice, financial planning, drafting and bargaining with the creditors, or supervision of repayment. But it is worth noting that Agarwal et al.’s study on the effects of mandatory third-party review of mortgage contracts in the US show that counselling has only an indirect effect on mortgage choices. Counselling is perceived as a burden by borrowers, who therefore either stay away from the market altogether or substitute mortgages with lower risk in order to avoid counselling. According to the authors, despite intensive counselling, the aggregate effect of

46. Posner, n. 40 above, 283, 301 et seq. Usury laws for example, are a useful means to indirectly limit the extension of credit to high-risk borrowers. Since the creditor will not be able to compensate this extra risk by bargaining for a high interest rate he will loose his incentive to lend to low-income persons.

47. Sunstein, n. 15 above, 249, 267.

48. Block-Lieb and Janger, n. 15 above, 1481, 1560.

49. For an overview of methods see Hoffmann, n. 10 above, 266 et seq. Means of alleviating over-indebtedness are certainly equally important. These are especially debt counselling and consumer bankruptcy. Cf. e.g., DG Employment, Social Affairs and Equal Opportunities, Towards a Common Operational European Definition of Over-Indebtedness, February 2008, 8–9; U. Reifner, J. Kiesiläinen, N. Huls and H. Springeneer, Consumer Overindebtedness and Consumer Law in the European Union, Final Report presented to the Commission of the European Communities, Health and Consumer Protection Directorate-General, September 2003, 162 et seq.


counselling on mortgage decisions is nominal. But the mere presence of a regulator in the market-place and the third-party review has a large effect on the quality of mortgages originated. They observe that low-quality lenders exit the market, and the quality of loans originated by the remaining lenders increases.52

– Disclosure mandates: Disclosure is supposed to facilitate consumers informed choice among the many competing products.53 More information helps people make better decisions, thus strengthens their autonomy. Until today disclosure mandates were the main regulatory response to the problem of consumer misperception, especially in the EU.54 Information disclosure rules are easy to secure an agreement on, since they are supporting party autonomy and thereby go in-line with the principles of free market economy. Therefore disclosure mandates are often tried before more obtrusive regulation is considered. But in the EU context they are probably often also reflecting a choice of convenience rather than a choice based on rational arguments in favour of disclosure versus other regulatory options.55 Indeed, the 2008 Consumer Credit Directive (CCD) also chooses to introduce long and detailed information requirements for advertisements concerning credit agreements, for the phase before contract conclusion (Articles 5–7) and at contract conclusion (Articles 10–12).56

However, the effectiveness of disclosure mandates is questioned.57 This measure can only have success if the average consumer is also capable

53. Cf. e.g., Avgouleas, n. 22 above, 440, 447 et seq. (2009). For critics in regard of the current paradigm of disclosure regulations focusing mainly on informing the consumer about product attributes without giving individualized information about possible future use patterns of this product, like e.g., the amount that an average credit card user pays in late fees and, how much the individual consumer has paid in late fees over the last year, cf. Bar-Gill, n. 30 above, 749, 797 et seq.
56. Cf. on these information duties E. Čikara, Gegenwart und Zukunft der Verbraucherkréditverträge in der EU und in Kroatien (Wien: Lit Verlag, 2010), 223 et seq.; Garcia Porras and van Boom, n. 35 above, 11–15.
of understanding what exactly he is informed about and can make use of this knowledge. Information is more useful to well-educated and well-off people who have the resources to locate, interpret and use the revealed information well. In most of the cases it remains a self-deceptive measure due to widespread lack of sophistication and innumeracy on the side of the consumer. Detailed disclosure requirements make it almost impossible to understand them without expert counsel. Ever expanding lists with information overloads consumers and renders the notice counterproductive.

In fact, if information could have helped by itself, the subprime mortgage crisis would not have lead to so many foreclosures with its devastating effects on financial markets. The above-mentioned cognitive problems are generally so great that people frequently lack an adequate command of the information they get in order to make good decisions. Especially in case of consumer credit people’s problems with their choices go well beyond informational insufficiency. Hence, the information model works with the wrong premise. To seek a solution solely by means of information duties leaves the risk of misinterpreting or misunderstanding on the consumer. Here the paradigm remains ‘responsible borrowing’ without any emphasis on responsible lending. Therefore, without denying the positive effects Bar-Gill’s suggestion64 to individualize disclosure and to add, e.g., a warning on the credit card bill like ‘Debt increasing – at your current repayment rate, it will take you thirty-four years to repay your debt and you will end up paying 300% of the principal’ might have, it is submitted that the lawmakers should not stop here but go on seeking for other alternatives to hinder irresponsible lending.

Mandate to assist:65 In fact, in addition to the information duty, Article 5(6) of Directive 2008/48 introduces, other than its forerunner 87/102/EEC, a duty for creditors and, where applicable, credit intermediaries [to] provide adequate explanations to the consumer, in order to place the consumer in a position enabling him to assess whether the proposed credit agreement is adapted to his needs and to his financial situation, where appropriate by explaining the pre-contractual information to be provided in accordance with paragraph 1, the essential characteristics of the products proposed and the specific effects they may have on the consumer, including the


59. Cf. Weatherill, n. 55 above, 181; Garcia Porras and van Boom, n. 35 above, 17–19. According to Ben-Shahar and Schneider ‘Mandated disclosure is a Lorelei, luring law-makers onto the rocks of regulatory failure’ Ben-Shahar and Schneider, n. 57 above, 23.

60. Block-Lieb and Janger, n. 15 above, 1481, 1561.

61. Avgouleas, n. 22 above, 440, 457; Ben-Shahar and Schneider, n. 57 above, 25.

62. Ben-Shahar and Schneider, n. 57 above, 48 et seq.


64. Bar-Gill, n. 30 above, 749, 800–801.

consequences of default in payment by the consumer.\textsuperscript{66} But how this vague duty is going to be interpreted by the Member States’ courts remains to be seen.\textsuperscript{67} The Recitals mention that despite the pre-contractual information the consumer may still need additional assistance in order to decide which credit agreement, within the range of products proposed, is the most appropriate for his needs and financial situation. Therefore, Member States should ensure that creditors provide such assistance in relation to the credit products, which they offer to the consumer.

The Legislative Proposal, explaining the German provision transposing this duty in Article 491a(3) of the Bürgerliches Gesetzbuch (BGB) quite literally, is especially underlining that the lender has no counselling duty.\textsuperscript{68} It is only assistance in relation to the credit products offered by the creditor and shall help the consumer to understand and distinguish among these products.\textsuperscript{69} Given the fact that with Directive 2008/48 a Europe wide credit market is aimed at,\textsuperscript{70} the interpretation of the German legislator that the lender may fulfil his explanation mandate by a standardized form seems to be correct. As long as the creditor has no reason to believe that the consumer has a special need for assistance it can assume that explanations targeting an average consumer are sufficient.\textsuperscript{71} But according to the level of complexity the expectations regarding assistance prior to the conclusion of the contract will rise. § 6(5) of the Austrian Consumer Credit Law\textsuperscript{72} is parallel to the German one and limits itself to reproducing the text of the Directive without going into details. Yet, the newly inserted Article 55A of the UK Consumer Credit Act 1974\textsuperscript{73} chooses to further elaborate on the content of these pre-contractual explanations and trying thereby to give the courts as well

\textsuperscript{66} Article 6(3) of the 2002 Proposal, n. 9 above, was providing for a more detailed duty to advise: ‘The creditor or, where applicable, the credit intermediary shall seek to establish, among the credit agreements they usually offer or arrange, the most appropriate type and total amount of credit taking into account the financial situation of the consumer, the advantages and disadvantages associated with the product proposed, and the purpose of the credit.’

\textsuperscript{67} Cf. also J. Kündgen, ‘Policy Responses to Credit Crises: Does the Law of Contract Provide an Answer?’, in this volume, above 53–54.


\textsuperscript{69} Recital 27 of Directive 2008/48 on Credit Agreements for Consumers. Cf. regarding the ‘suitability’ control requirement in MiFID Art. 19(4) Moloney, n. 58 above, 341, 403 et seq.

\textsuperscript{70} Recitals 4–7 of Directive 2008/48 on Credit Agreements for Consumers.

\textsuperscript{71} Gesetzentwurf der Bundesregierung, n. 68 above, 121.


\textsuperscript{73} Amended by The Consumer Credit (EU Directive) Regulations 2010, Part 2, Regulation 3.
as creditors and credit intermediaries a guideline at hand. Standing out is the
duty of the creditor to advise the debtor on the features of the agreement
‘which may operate in a manner which would have a significant adverse
effect on the debtor in a way which the debtor is unlikely to foresee’.

But since a sanction for omitting such assistance is not provided for
under the Directive, and the Member States are only obliged to introduce
penalties, ‘which are effective, proportionate and dissuasive’ (Article 23)
no special provision can be fathomed in the transposition measures of e.g.,
Germany, Austria or UK. In Germany, it is proposed to apply the general
principles of contract law regarding *culpa in contrahendo* that is bargaining
in good faith.74 According to § 241(2) BGB an obligation may also, depend-
ing on its content, oblige each party to take account of the rights, legal
interests and other interests of the other party. Such an obligation may
come into existence already by the commencement of contract negotiations
(§ 311(2) BGB). This triggers a damages claim based on § 280 BGB in order
to cover the reliance interest of the consumer.75 If for example, the creditor
has omitted to inform the consumer on its different products available and
there was one, which was more suitable for the needs of the consumer, the
creditor will have to compensate the losses encountered. In Austrian litera-
ture it is argued, that apart from the *culpa in contrahendo* claim the con-
sumer has also a right to avoid the contract due to the fact that he was
mistaken in regard of the credit agreement options.76

Other: Besides these more target oriented means of preventing over-
debtedness, maintenance of a competitive market, fight with illegal
moneylenders and unfair commercial practices are certainly equally impor-
tant measures but cannot be elaborated on here any further.

VI. A LESS EXPLORED METHOD OF PREVENTING
OVER-INDEBTEDNESS: DUTY OF
RESPONSIBLE LENDING

A. COMPARATIVE LAW

1. The 2002 Proposal of the EU

The 2002 EU Proposal for revising the CCD was aiming at ‘improving the quality
of loans and lessening the risk of consumers falling victim to disproportionate

74. For example, Rott, n. 68 above, 1104, 1110; parallel for Austrian law B. Zöchling-Jud, in
C. Wendehorst and B. Zöchling-Jud, *Verbraucherkreditrecht* (Wien: Manz Verlag, 2010),
§ 6 VKrG para. 75. But cf. Herresthal, n. 68 above, who rejects such damages claim at 1180.
75. Cf. on this e.g., B. Markesinis, H. Unberath and A. Johnston, *The German Law of Contract,
commitments that they are unable to meet, resulting in their economic exclusion and costly action on the part of Member States’ social services’ by proposing provisions relating to the prevention of over-indebtedness.77 The principle of ‘responsible lending’ was introduced in Article 9 according to which the creditors were obliged to assess by any means at their disposal, whether the consumer could reasonably be expected to discharge its obligations under the credit agreement about to be concluded, or any subsequent increase of the total amount of credit.78 To this end, the credit institutes should consult centralized databases (Article 8(1)), examine the replies provided by the consumer or the guarantor, request the provision of sureties, check the data supplied by credit intermediaries and select the type of credit to be offered according to this information.79 According to Article 8 of the Proposal, each Member State had to introduce a central database holding negative, neutral and reliable data recording late payments, containing identification of consumers and guarantors and thereby creating a common platform for accessing, processing and consulting data.

The explanatory memorandum of the 2002 Draft Directive made it clear that the consequence of extending an irresponsible credit is ‘the imposition of civil and trade sanctions’.80 Article 31 of the Proposal stresses that the penalties must be effective, proportionate and must constitute a deterrent. The Draft provision gives also an example for such penalty, which is in particular to be applied in case of irresponsible lending on the side of the creditor: the creditor loses his claims for interest and charges even though the consumer can continue to repay the loan back in instalments. But obviously the Member States were left free to choose the concrete sanctions.

2. Switzerland81

The Swiss Federal Law on Consumer Credit of 2001 (in force since 1 January 2003), requires all creditors to establish together an Information Centre for Consumer Credit (Article 23).82 Creditors must inform this Centre on each credit they

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77. Explanatory Memorandum of the 2002 Proposal, n. 9 above, 7–8.
have extended to a consumer. Besides, any case where a consumer is in arrears for an amount adding up to 10% or more of the total credit has to be reported to the bureau. This information duty is also extended to leasing and credit card contracts. Whenever three successive instalments are outstanding or the consumer has made use of an overdraft facility three times for a sum totalling more than 3,000 Swiss Franc, the Centre has to be informed.

The information gathered at the Centre needs to be consulted by creditors in order to verify the creditworthiness of the consumer. This inquiry is conducted before concluding the contract. Creditworthy is every consumer who can repay the credit without burdening the portion of revenue that cannot be seized according to Article 93(1) of the Swiss Federal Law on Debt Enforcement and Bankruptcy (Article 28). The unseizable portion of the revenue has to be defined according to the directives of the Canton where the consumer is domiciled. The evaluation has to take account of the monthly rent and taxes and other obligations of the consumer registered at the Information Centre. For any leasing contract the same rule is applicable (Article 29). However, an exception is made in case the consumer can give a pledge for his obligation. Only for credit cards and current account overdraft facilities the legislator has taken a more tolerant stance (Article 30). The credit limit is calculated taking into account the consumer’s revenue and financial situation – the unseizable amount must not be considered. But, whenever the credit institution is informed about a change in the financial situation of the consumer it has to repeat the creditworthiness check and act upon the results.

The sanctions of violating the rules on responsible lending are harsh. If the creditor has seriously neglected its duties regarding the evaluation of creditworthiness, he loses his claim for payment of the credit and interest (Article 32(1)). The consumer may even demand restitution of his previous payments. If the creditor’s violation is less serious or he has omitted to report to the Information Centre he only loses his claim for interest and expenses, but he can demand repayment of the credit sum (Article 32(2)).

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85. Giger, n. 84 above, 84; S. Kilgus, ‘Kredit- und Kundenkarten als Zahlungs- und Kreditinstrumente nach revidiertem KKG’, in Brunner, Rehbinder and Stauder (eds), n. 84 above, 127, 144 et seq.
3. Japan

The Japanese Moneylenders Law was revised and enacted on 20 December 2006 (Law No. 115).\footnote{The translations of the relevant provisions and texts were provided by Prof. Dr. Yuko Nishitani, whom I thank wholeheartedly.} The provisions of this law regarding responsible lending are applicable as of June 2010.\footnote{Cf. Kozuka and Nottage, n. 31 above, 199, 203; S. Kozuka and L. Nottage, ‘Re-regulating Unsecured Consumer Credit in Japan: Over-indebted Borrowers, the Supreme Court, and New Legislation’ (September 2007) Sydney Law School Research Paper No. 07/62 (<http://ssrn.com/abstract=1019392>); A.M. Pardieck, ‘Japan and the Moneylenders – Activist Courts and Substantive Justice’ 17 Pacific Rim Law & Policy Journal 529, 579 (2008).} According to these rules, moneylenders\footnote{These rules are only applicable to establishments registered according to Art. 3 of this Law as ‘moneylenders’. Establishments which are subject to other laws, especially banks are not ‘moneylenders’ in the sense of this law, cf. T. Ueyanagi and Y. Omori, Chikujo Kaisetsu – Kashikin Gyô Hô (Tokyo, 2008), 53.} have to check on borrowers’ ability to repay by evaluating their income and other assets, the credit and its terms and other relevant factors (Article 13(1)). The records of the credit bureau have to be consulted whenever an individual takes a loan (Article 13(2)). Where the lender offers a loan exceeding JPY 500,000 or a loan that results in debts of more than JPY 1 million, he must also obtain written proof of the annual income (Article 13(3)).\footnote{Cf. on these provisions Ueyanagi and Omori, n. 89 above, 104 et seq.} According to Article 13\textsuperscript{bis} (1) with the heading ‘Prohibition of excessive loans’ the moneylender shall not extend a credit to an individual whenever creditworthiness is not granted. The total amount of credit given by moneylenders shall not exceed one-third of the borrower’s annual income, except a loan for acquiring immovable property or an automobile is given (Article 13\textsuperscript{bis} (2)). If the moneylender violates this rule Article 48(1) provides for either a prison sentence of one year or a fine of maximal JPY 3 million.

4. South Africa

The South African National Credit Act of 2006\footnote{National Credit Act No. 34, Government Gazette No. 28619, 15 Mar. 2006.} devotes its Chapter 4 Part D to ‘Over-indebtedness and reckless credit’.\footnote{Cf. in detail M. Kelly-Louw, ‘Prevention of Overindebtedness and Mechanisms for Resolving Overindebtedness of South African Consumers’, in Niemi, Ramsay and Whitford, n. 11 above, 175 et seq.; S. Renke, M. Roestoff and B. Bekink, ‘New Legislative Measures in South Africa Aimed at Combating Over-Indebtedness – Are the New Proposals Sufficient Under the Constitution and Law in General?’ 15 International Insolvency Review 91, 102 et seq. (2006).} According to section 80 a credit agreement is reckless if at the time the agreement was concluded, or at the time when the amount is increased:

– the credit provider failed to conduct an assessment as required by section 81(2), irrespective of what the outcome of such an assessment might have concluded at the time; or
– the credit provider, having conducted an assessment as required by section 81(2), entered into the credit agreement with the consumer despite the fact that the preponderance of information available to the credit provider indicated that
– the consumer did not generally understand or appreciate his risks, costs or obligations under the proposed credit agreement; or
– entering into that credit agreement would make the consumer over-indebted.

According to section 81(2) the assessment has to be regarding the consumer’s
– general understanding and appreciation of the risks and costs of the proposed credit, and of the rights and obligations of a consumer under a credit agreement;
– debt re-payment history as a consumer under credit agreements;
– existing financial means, prospects and obligations; and
– whether there is a reasonable basis to conclude that any commercial purpose may prove to be successful, if the consumer has such a purpose for applying for that credit agreement.

If a court declares that a credit agreement is reckless it may make an order setting aside all or part of the consumer’s rights and obligations under that agreement, as the court determines just and reasonable in the circumstances; or suspend the force and effect of that credit agreement (Article 83).93 Besides being reckless, the credit may also cause the consumer to get over-indebted. Under such circumstances the court must further consider whether the consumer is over-indebted at the time of those court proceedings and if it so it may make an order suspending the force and effect of that credit agreement until a date determined by the court when making the order of suspension; and restructure the consumer’s obligations under any other credit agreement (Article 85).

5. France

Although the French Consumer Code included no special provision regarding the duty of creditors to check creditworthiness of their customers, the Court of Cassation in a series of decisions questioned whether the credit grantor breaches its contractual duty of care if he does not verify the financial capacity of the borrower and warn him in case of excessive borrowing. The Court came to the conclusion that banks are to be held liable whenever the borrower is a consumer and it was foreseeable at the time of contract conclusion that the debt ratio would inevitably lead to over-indebtedness.94 But the question, to what extent the creditors are liable


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if the consumer cannot pay back his credit, is left open in the decisions. This is probably due to the fact that after reversal of the Court of Cassation the Court of Appeal had to decide on the matter.95

6. Article 8 of Directive 2008/48 on Consumer Credits and Some National Transposition Measures

Other than the 2002 Proposal, Directive 2008/48 chooses not to engage at all with the problem of responsible lending. Even the Recitals (no. 26) show that everything is left to the discretion of the Member States: ‘It is important that creditors should not engage in irresponsible lending or give out credit without prior assessment of creditworthiness, and the Member States should carry out the necessary supervision to avoid such behaviour and should determine the necessary means to sanction creditors in the event of their doing so.’ A harmonization was not envisaged in this field.

Accordingly, Article 8 of the Directive just instructs Member States to ensure that credit institutes are under the obligation to assess the creditworthiness of the consumer before the conclusion of the credit agreement. This has to be done on the basis of sufficient information, where appropriate to be obtained from the consumer and, where necessary, by way of consulting a relevant database.96 But the Directive does not anymore include the proposed provision regarding a duty of responsible lending or an obligatory check of databases. It also abstains from defining the criteria of creditworthiness or the consequences of opening a credit despite a negative assessment result. Naturally, the provision on penalties does not mention anymore the violation of the duty of responsible lending. Therefore it is unclear whether the Member States’ duty, to introduce penalties ‘which are effective, proportionate and dissuasive’ (Article 23 Directive), aims merely at administrative sanctions or also at adjudicating individuals a right to, e.g., refuse to pay interest or claim damages in case of omitted assessment of creditworthiness.

The German legislator has chosen to use the granted discretion in favour of creditors. It introduced a creditworthiness check for consumer credits in Article 18(2) of the Banking Act (Kreditwesengesetz)97 without any specific penalty...
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for the case of omitting such check. The legislator states in the explanatory notes that the Federal Banking Supervisory Office will be in charge of monitoring. This decision is telling, given the fact that paragraph 1 of the same article is the provision, which regulates the requirements for loans to a single borrower amounting in the aggregate to more than EUR 750,000 or 10% or more of the liable equity of the institute. Such credit can only be granted if the credit institute requires the borrower to disclose his financial circumstances, in particular by submitting his annual accounts. This way it is aimed at preventing an excessive concentration of exposure to a single client or group of connected clients which may result in an unacceptable risk of loss. Granting a loan in violation of this assessment duty is fined pretty high, with EUR 150,000. But the German legislator did not consider applying a similar fine in case a consumer credit is extended without any check. Apparently, the risk for credit institutes, posed by a multitude of subprime loans which are unrecoverable, is not judged that high. How correct this judgment still is after the global financial crisis is very questionable.

Since the amendment of the Austrian Consumer Credit Act § 7 in June 2010 creditors are obliged to assess creditworthiness of the consumer on the basis of sufficient information and if needed by consulting a database. Unlike the German provision, under Austrian law the creditors have also a duty to warn the consumer in case the assessment shows that the consumer is going to encounter problems paying the loan back (§ 7(2)). But the final decision whether or not to take the credit is left to the consumer. The explanatory notes to the Proposal expressly state that the creditor is not acting unlawful if he extends the credit although knowing that the consumer will hardly be able to pay it back. Just like the Directive, the Austrian law has also omitted an express reference to the civil law liability of the creditor, which it had included in previous draft proposals. In principle, if a creditworthiness assessment is not conducted an administrative sanction is applicable and a fine of up to EUR 10,000 can be imposed. But it is

98. The German literature is split in regard of the civil law remedies a violation of Art. 18(2) of the Banking Act might entail. V. Vorwerk, ‘Schutz in der Finanzmarktkrise – Welche Rechte hat der Verbraucher?’ Neue Juristische Wochenschrift 2009, 1777, 1781–1782 and Herresthal, n. 68 above, 1174, 1176–1178 are rejecting any such remedy, whereas Rott, n. 68 above, 1104, 1110; Ch. Hofmann, ‘Die Pflicht zur Bewertung der Kreditwürdigkeit’ Neue Juristische Wochenschrift 2010, 1782, 1786 are in favour of a damages claim of the consumer based on the violation of a contractual duty.
99. Gesetzesentwurf, n. 68 above, 144.
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significant that the explanatory notes to the Proposal state that the assessment and warning duties are accessory duties of the creditor arising of a pre-contractual relation with the consumer. Therefore, according to the Proposal, by conception these duties belong in the realm of civil law and a violation of such accessory duties may lead to a damages claim. The Proposal even names as an example for losses encountered by the consumer the default interest he had to pay.\(^{104}\) As a matter of fact, in Austrian literature the prevailing view seems also to advocate the application of civil law sanctions and to give the consumer at least the right to reject payment of default interest.\(^{105}\)

The newly introduced Article 55B of the UK Consumer Credit Act 1974\(^{106}\) provides also for a duty to assess creditworthiness of debtors. Just like in the Directive, this assessment must be based on sufficient information obtained from the debtor and where appropriate from a credit reference agency. But given the fact that the amendment abstains from mentioning any special penalty, the applicability of Articles 140A and 140B of the Consumer Credit Act regarding ‘unfair relationships between creditors and debtors’ should be considered. In case a court finds the credit agreement unfair according to these provisions it may intervene into the contract and may require the creditor to repay any sum paid by the debtor or even reduce or discharge any sum payable by the debtor.\(^{107}\)

A clear-cut civil law penalty can be found in the French provision. Although the new version of Article L 311-9 of the Code de la consommation, which comes into force as of 1 May 2011 and transposes Article 8 of the Directive into French Law, only reproduces the text of the Directive, Article L 311-48(2) defines the sanction for disrespecting the obligation to check creditworthiness: The Judge may waive the right for interest in total or partially. This seems to take account of the previous court decisions where a claim of the bank for interest was refused whenever the contractual duty of care was breached.\(^{108}\)

B. Assessment of the Different Approaches

Looking at the different models presented here, two statements can be made:

– They all introduce a duty for creditors to assess the creditworthiness of the consumer, but

\(^{104}\) 650 der Beilagen XXIV. GP – Regierungsvorlage – Vorblatt und Erläuterungen, 18.


\(^{108}\) Cf. above n. 95.
They differ in the sanctions they choose in case an assessment is missing. The options are either a public law control, sometimes combined with a penalty, or civil liability of the creditor. Here again the rights of the consumer range from release of interest and charges, to release of the credit in total and restitution of the sum paid to the creditor.

Several arguments can be raised in favour of the first choice, that is, to introduce an obligatory creditworthiness assessment. First of all, research results regarding the cognitive biases of consumers lead to the conclusion that creditors are the better decision makers when it comes to borrowing. Although this might sound paternalistic at first, it should not be disregarded that credit institutes are collecting the data of individuals already for years. The financial sector has long established practices of scoring and evaluating consumers via risk modelling programmes. They have developed considerable expertise in screening and monitoring. Data available to banks is more complete and accurate than the consumer can ever recollect. As Pottow rightly puts it: ‘Your credit card company knows how much you should borrow better than you do.’ This unique position of financial institutions is also the reason why we differentiate between a seller and a bank: The seller is often a one-time contract party. The credit institution however is a life-time partner. A creditor who has all the relevant information at hand is obviously also the cheapest cost bearer in regard of evaluating this information. But, as evidenced in several publications, lenders do not use the knowledge regarding high-risk borrowers to turn down their applications but to actively encourage them in order to extend credit to this group at substantially higher rates. And exactly this is the problem that has to be confronted.

As a matter of fact, in many countries credit-risk assessment is already imposed on banks due to public law regulations. One of the major goals of the Basel II criteria and also the Directives on capital adequacy of credit institutions are to introduce supervisory regulations governing capital requirements in order to strengthen the soundness and stability of the banking system.

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109. Cf. in detail Pottow, n. 13 above, 405, at 431 et seq.
110. Purnanandam, n. 21 above, 1.
115. Cf. Ohler, in Derleder, Knops and Bamberger (eds), n. 100 above, § 76 paras 1–3 and paras 44 et seq.
It is for preserving the integrity of capital that credit institutes have to assess creditworthiness. But such an assessment is only obligatory for credits where excessive concentration of exposures to a single client or group of connected clients may result in an unacceptable risk of loss.\textsuperscript{116} The Basel accords are mainly intended for the protection of banks, investors and public interest, not any borrower. In case a credit institute violates these requirements sanctions are imposed by public law and not private law. The borrower himself cannot refer to these provisions to substantiate a damages claim if the bank lends in a reckless way.\textsuperscript{117}

This is certainly one way to look at things. By imposing a fine on the creditor negative externalities of reckless lending are corrected to some extent. But obviously the level of the fine is crucial in this context. A suggestion that comes from Ronald Mann for the credit card sector is the introduction of a ‘distressed debt tax’.\textsuperscript{118} That is, a Pigovian tax levied in order to compensate for the negative externalities of the credit card business. The government would collect an annual tax calculated as a percentage of all credit obligations that became delinquent the preceding year.\textsuperscript{119} This way the creditors would have to internalize some of the negative effects of their risky business model and start thinking of changing this.

But I doubt whether this is an appropriate angle to look at the question at hand. Other than in the case of preserving the integrity of capital, in case of reckless lending the creditor’s behaviour is directly linked to the over-indebtedness of the consumer. Due to omitting an assessment or extending a credit despite negative outcome of the assessment the creditor is intentionally putting up with the harmful effects on the consumer. Therefore, to accept a direct civil law claim of the consumer against the bank would bring about an acknowledgement of this private harm without just focusing on the negative social welfare effects of over-indebtedness.\textsuperscript{120} If both, borrower and creditor, can limit social losses then the risk should also be allocated between them.\textsuperscript{121} To relieve the borrower once he is over-indebted by way of consumer bankruptcy provisions is missing exactly this point. That is, the role of the creditor in the path leading to over-indebtedness is neglected. The consumer and his family will have to live with the stigma of going bankrupt while the bank can go on practicing its irresponsible lending practices. This does not seem to convince.

\textsuperscript{116} Recital 48 of Directive 2006/48 on Credit Institutions, n. 114 above.
\textsuperscript{117} For Germany cf. e.g., Blaurock, n. 11 above, 697, 704–705; Tonner, in Derleder, Knops and Bamberger (eds), n. 102 above, § 4 para. 44; Bock, in K.H. Boos, R. Fischer and H. Schulte-Mattler, Kreditwesengesetz (3rd edn, Munich: Beck Verlag, 2008), § 18 para. 3.
\textsuperscript{119} Mann, n. 118 above, 195.
\textsuperscript{120} Pottow, n. 13 above, 405, 440.
\textsuperscript{121} Mann, n. 118 above, 203.
VII. CONCLUSION

A problem as multifaceted as over-indebtedness cannot have a one-size-fits-all solution. An eclectic and interdisciplinary methodological toolkit, as put forward by Kozuka and Nottage, seems to be preferable given the complexity of the problem. The classical methods of empowering the weaker contract party via financial education, counselling or disclosure mandates are certainly still well founded, but may not be enough. There are lessons to be learnt from the US subprime mortgage crisis. The short-term profit fixation of financial institutions combined with different methods of externalising credit default risk (‘originate to distribute model’) or minimizing it via high default interest rates and fees, interferes with the institutions incentive to screen or monitor consumers. This leads to reckless lending practices which systematically exploit the biases of the consumer. Often, a standard information sheet handed over to the consumer before contract conclusion cannot suffice to contravail the abuse. This market failure, leading to inefficient contracts and an alarming increase in the loans to household volume in Europe asks for new measures to be discussed. Even the cursory comparative remarks above show that there are many examples which may inspire.

Obviously a regulation must first give guidance in regard of underwriting standards. A telling example for the importance of underwriting standards is pointed out by Bar-Gill, n. 22 above, at n. 126 referring to B. Appelbaum and E. Nakushima, ‘Banking Regulator Played Advocate Over Enforcer – Agency Let Lenders Grow Out of Control, Then Fail’ Washington Post, 23 Nov. 2008: according to the authors the Office of Thrift Supervision in the US remained reluctant to insist on higher lending standards for adjustable rate mortgages, yet even after other bank regulators urged for it. The long delay in issuing the guidance allowed companies to keep making billions of dollars in loans without verifying that borrowers could afford them. One of the largest banks, Countrywide Financial, said in an investor presentation after the guidance was released that most of the borrowers who received loans in the previous two years would not have qualified under the new standards. Countrywide said it would have refused 89% of its 2006 borrowers and 83% of its 2005 borrowers. That represents USD 138 billion in mortgage loans the company would not have made if regulators had acted sooner.
credit register\textsuperscript{125} must be established in each Member State providing unlimited access also to creditors of other Member States. An omission of assessment based on the defined criteria, or credit extension despite a negative result to the assessment should trigger contractual liability.\textsuperscript{126} Here, it is submitted, that the provisions of the Swiss Consumer Credit Code seem to be the most convincing. Given their radical nature they are best suited for deterring financial institutions from reckless lending practices. Violation of the rules shall either lead to the writing off of the credit in total or at least interest and expenses. Certain discretion should be given to the judge so that he can take specific facts of the case into account. The two shadow sides of this solution are the increase in credit costs due to increase of the risk premium and the danger of excluding high-risk borrowers from the market.\textsuperscript{127} But a more honest solution to these problems could also be introducing a public fund providing credit to low-income borrowers.

\textsuperscript{125} Cf. on different types of registers throughout Europe and a proposal to introduce public credit registers as the best way to reconcile the essential needs of credit institutes for information about credit applicants and the respect for data protection laws Ferretti, n. 112 above 1, 19 et seq.


\textsuperscript{127} Cf. on this Reifner, n. 14 above, 383, 400 et seq.; Rott, n. 126 above, 173, 193–195.