Systemic Usury and the European Consumer Credit Directive

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Summary: Usury is a frequent occurrence in consumer credit markets and particularly affects low-income households. Although the term usury conjures images of a greedy individual consciously acting to exploit the weak bargaining position of another by deceitful and even fraudulent means, we consider it as a systemic issue: as a problem of social discrimination, where belonging to a group which is statistically discriminated against leads to entrapment in a chain of usurious credit and financial contracts.

This paper reviews the economic rationale for usury legislation and evaluates the European Consumer Credit Directive 2008/48/EC in this context. It identifies systemic usury as the product of market failure: the most powerful explanations for which are monopoly power, where the consumer is locked in a bilateral credit relationship; discrimination through risk-based pricing, and negative externalities. Contrary to the main focus of the European Consumer Credit Directive, improved disclosure of contract terms and other relevant information to consumers at the point of contracting cannot address systemic usury in credit markets. Even fully informed consumers can be discriminated against and become trapped in a situation of bilateral monopoly. As a consequence, the Directive is found to be ineffective: it implicitly acknowledges usurious practices and products as legal and undermines the national fight against usury. The Directive must be reformed.

Zusammenfassung: Wucher ist ein häufiges Phänomen auf den Verbraucherkreditmärkten und betrifft insbesondere Haushalte mit niedrigem Einkommen. Obwohl der Begriff Wucher Bilder eines gierigen Individuums beschwört, das bewusst handelt, um die schwache Verhandlungsposition eines anderen mit irreführenden und sogar betrügerischen Mitteln auszunutzen, betrachten wir ihn als systemisches Problem: als ein Problem der sozialen Diskriminierung, bei dem die Zugehörigkeit zu einer statistisch diskriminierten Gruppe zu einer Einklemmung in eine Kette von wucherischen Kredit- und Finanzverträgen führt.

Dieses Papier untersucht die ökonomischen Argumente für die Wuchergesetzgebung und bewertet in diesem Zusammenhang die Europäische Verbraucherkreditrichtlinie 2008/48/EG. Es identifiziert systemischen Wucher als das Ergebnis von Marktversagen: Die überzeugendsten Erklärungen dafür sind Monopolmacht, bei der der Verbraucher in einer bilateralen Kreditbeziehung gefangen ist, Diskriminierung durch risikoorientierte

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Preisgestaltung und negative Externalitäten. Im Gegensatz zum Hauptaugenmerk der Europäischen Verbraucherkreditrichtlinie kann eine verbesserte Offenlegung von Vertragsbedingungen und anderen relevanten Informationen für die Verbraucher zum Zeitpunkt der Vertragsunterzeichnung nicht auf systemischen Wucher auf den Kreditmärkten abzielen. Selbst voll informierte Verbraucher können diskriminiert werden und in einer Situation des bilateralen Monopols gefangen sein. Infolgedessen erweist sich die Richtlinie als unwirksam: Sie erkennt implizit wucherische Praktiken und Produkte als legal an und untergräbt die nationale Bekämpfung von Wucher. Die Richtlinie muss reformiert werden.

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1 Introduction

The term usury refers to the exploitation of unequal bargaining power to the extent that the resulting contracts place one of the parties under excessive obligations to the other. In modern capitalist economies, the term can refer to the payment of excessive prices for goods and services received, or in respect of employment contracts, to extremely low wages relative to the labour provided[1].

Transactions with usurious content are declared null and void in German civil law. § 138 BGB. § 291 of the Criminal Code makes usury a punishable offence, and particularly emphasises usury in credit and housing markets, but also includes usury in respect of wages (BAG v. 22. 04. 2009 – 5 AZR 436/08).

In cases of *individual usury* (§ 138 Abs. 2 BGB) the usurer consciously and purposefully exploits the misfortune or weakness of another to impose upon them excessive contractual burdens: the legal as well as moral basis of a finding of usury relies on identifying the malice of the specific lender, landlord, or employer. This may include providing evidence of deception, fraud, overreaching, or greed.

However, *systemic usury* (= social usury § 138 Abs. 1 BGB) can also exist in the form of social discrimination. In this case, the socially weak position of some population groups manifests itself as a seemingly personal attribute of an elevated risk for each individual member, and thus results in contracts which are usurious in nature. In these instances, it is the effect of usury on groups of borrowers, tenants, or employees (e. g. over-indebtedness, impoverishment) which the law seeks to prevent.

The law therefore speaks of a threshold: the conspicuous imbalance between the agreed price or wage and a 'typical' or 'normal' cost or remuneration. In labour law, this benchmark is derived from the standard wage; in credit law from the average interest rates assessed by the European Central Bank ('ECB'); and in tenancy law, from the average rents for comparable dwellings as recorded in the rent indexes of local authorities. The courts set the floor for wages at one third below the average and the ceiling for rents at two thirds above average. However, in German credit law the interest cost must be twice the average to be considered conspicuous (in France and Italy it is two-thirds).

1 On the economic analysis of the historical criticism of usury and interest in credit markets, see Hecker (2019).

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Ultimately, the decisive factor is whether the wage or price deviates so conspicuously from the typical level that one has to assume that a market failure has occurred.

Because the terms on which people are employed, housed, and can access credit (i. e. draw down against their anticipated future income) have an existential significance, the problem of systemic usury is one of critical importance. This is particularly the case for lower income groups, who are most affected. These groups have the least access to advice at the point of contracting; and are often desperate for work, housing, or credit. They are therefore in a disadvantaged bargaining position. With employers, landlords and banks, they are also faced with relatively powerful contractual partners who can dictate terms and develop a high degree of collective power.

These imbalances have been recognised by the law in a great many specific worker, tenant and consumer protections. These seek to ensure minimum standards in market operations. Social policies including housing subsidies, Hartz IV and social credits are also intended to alleviate the excesses that result. However, such policies increase, rather than decrease, the likelihood of social usury and there has been little interest to date in using the law to address this problem for the unemployed, housing seekers, and the over-indebted.

According to the German constitution, the principle of the welfare state requires not only greater social justice, but also the prevention of the abuse of economic power. There is therefore sufficient reason to reconsider the millennia-old ban on usury.

Against this background, Section 2 reviews the economic rationale for usury legislation with specific regard to consumer credit markets. Section 3 then summarises our recent evaluation of the European Consumer Credit Directive 2008/48/EC (CCD 2008) with regard to the spread of usurious credit in Europe. This evaluation was mandated by the German Coalition against Usury[2] in connection with the European Coalition for Responsible Credit (ECRC) (Reifner at al. 2019; see also Reifner 2018). Section 4 concludes.

2 Systemic Usury as Market Failure in Consumer Credit Markets

With the exception of Adam Smith, most classical economists believed that usury laws were "… mischievous interferences with the spontaneous course of industrial transaction" (Mill 1891; Coco and De Meza 2009, p. 1691). In his famous 'Defense of Usury', Jeremy Bentham (1787) argued that usury could not exist as long as the transaction was voluntary. In credit markets, usury limits prevented mutually agreed trades, and therefore reduced overall welfare by reducing the supply of credit.

This libertarian view is still shared by many neoclassical economists today (e. g. Labat and Block 2012, Baker and Breitenstein 2010) and in modern mainstream economics textbooks the word usury is usually missing. For these economists, mutually agreed trades *must* be beneficial to both parties and can never be exploitative or unfair (Labat and Block 2012, p. 385).

2 The German Coalition against Usury (www.stopwucher.de) is a joint initiative of German Consumer Advice Agencies ('Verbraucherzentralen'), Debt Advice Associations, Trade Unions, Consumer Attorneys and Academics. The German Coalition against Usury has adopted a declaration to stop the rise of usurious credit in Germany. The Coalition also contributes to the work of the international network of the European Coalition for Responsible Credit (ECRC).

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However, such an extremely libertarian view is no longer the consensus. For example, Mayer (2013, p. 516) highlights payday lending, “which Bentham never contemplated when he set out to defend usury”, as an example that wrongful gain can occur in voluntary, fully informed trade. And a widespread literature, burgeoning further since the financial crisis, has identified that consumer credit markets fail to deliver ‘fair’ outcomes for several reasons including: (1) monopoly power, (2) discrimination through risk-based pricing, (3) negative externalities and (4) imperfect information amongst consumers.

2.1 Monopoly Power

Monopoly power results in an inescapable relationship between the provider and consumers, and to ‘rent-seeking’ behaviour. We understand this best in terms of a monopoly provider in a specific market (such as energy), where neo-classical economists have long complained that a lack of competition can result in high prices and economic inefficiency. But monopoly power can also exhibit itself *systemically*. In the case of consumer credit markets, a profusion of providers has not prevented groups with weak bargaining power from becoming trapped in inescapable relationships with their lenders.

Groups of people with weak bargaining power have limited options. Even if they work just as well as others; even if their rent and instalments are always paid on time, they are only able to choose from providers who all present to them essentially the same offer: one involving considerably higher costs than the average. The problem is belonging to a group which is statistically discriminated against. This is the basis on which “The Poor Pay More” (Caplovitz 1963).

In the case of over-indebted borrowers on the threshold of insolvency (involving very impaired credit records) we also witness a problem of ‘bilateral monopoly’. In these cases, where the consumer needs additional credit, they must turn to their existing lender. Therefore, the customer is bound to the lender (lock-in), giving rise to a hold-up problem. Conversely, the lender is bound to the borrower by the credit default risk and is interested in extending the customer relationship by selling new products.[3]

In this case, the theoretical upper limit of the price is determined as if the lender were a sole supplier (monopolist) and the borrower is regarded as the quantity adjuster. The lower price limit results as a monopsony price from the reversed power constellation: if the customer is regarded as the only buyer (monopsonist) and the lender as the quantity adjuster. Whether the price is closer to the upper or lower limit depends in particular on three factors: (1) the negotiating skills of the contracting parties, (2) the stocks and financial reserves of the partners and (3) the status of information about the other partner (Schumann et al. 2011, pp. 313–314).

In the case of a given credit relationship between a threshold household and a lender, all three factors work to the detriment of the borrower, so that the monopoly price or a usurious offer is created: (1) The lender has greater negotiating skills, as it can credibly give the borrower the impression that it will break off negotiations if they fail to agree all the presented terms. Termi-

3 See also the literature of relationship lending, which explains a bilateral monopoly between a bank and a borrower by costly information production and information reusability over time. The incumbent bank’s information advantage over de novo lenders leads to a hold-up problem for the borrower (Boot 2000).

nation of the relationship would result in insolvency or high costs for the consumer, who does not have an alternative; due to the acceleration in case of early termination they would be left with an unsurmountable residual debt load instead of a single monthly instalment. (2) A consumer on the threshold of insolvency, unlike a lender, has too few financial reserves to delay contracting; (3) lack of information about the lender's position may weaken the relative power of consumers.

In a bilateral monopoly, at least one of the two partners must adopt a behaviour other than the monopolistic one. In principle, three combinations of behaviour are possible: (1) both partners behave as quantity adjusters because they consider their position to be too weak to determine the price; (2) a partner behaves as a monopolist because it considers itself so strong that it believes it can determine the price. The other partner is willing to accept this price as given and therefore behaves as a quantity adjuster; and (3) one partner assumes an even stronger position than the monopolist and therefore acts as an option fixer. The other partner accepts this option. In contrast to a monopolist, who can determine either the price or the quantity and leaves the choice of the other size to the market partner, an option fixer can determine both price and quantity. The option recipient then only has the choice of accepting the price/quantity combination offered or rejecting the transaction altogether (Schumann et al. 2011, pp. 313–314).

This economic theory cannot state under which circumstances which combinations of behaviours occur and which prices and quantities are formed in equilibrium. In the case of the credit relationship described above, however, it can be assumed that the lender has such a strong power position over a low-income household that it acts as the option fixer and the customer as the option recipient. Systemic usury in credit markets can thus be interpreted as a bilateral monopoly between a lender and a threshold household, whereby the lender fixes the price-quantity offers and thus abuses its monopoly power. This view is supported by empirical evidence that the demand for payday loans is relatively price inelastic, and that competition is ineffective (Avery and Samolyk 2011, pp. 4,19, Mayer 2013, p. 518).

Whilst an offer of an individual loan may often look good, usurious costs can arise for several reasons. Firstly, many lenders sell additional products such as payment protection insurance alongside the loan. It should be noted that lenders often *compel* consumers to take out these policies to ensure the repayment of their credit when borrowers encounter major financial problems (Ulbricht et al. 2019). According to a survey of the German Financial Authority ('BaFin'), the conclusion of a PPI is generally not obligatory, but in some cases customers with lower credit ratings receive a loan *only* if they take out a PPI policy (BaFin 2017, p. 31). These insurances are comparatively expensive. An investigation of 106 instalment credit offers including a PPI shows that the effective interest rate being charged, once the cost of the insurance is factored in, was more than double the market interest rate in half the cases. In some cases, the effective interest rate was even 25 percent (Ulbricht et al. 2019, p. 34, see also Größl and Peters 2019).

Secondly, loan contracts can stipulate an additional range of fees and charges to be paid by the borrower in a wide variety of likely events ('behavioural pricing'). Products can be structured in ways which make these events even more likely. For example, payday loans often require low income households to repay the entire balance within a very short space of time or incur heavy late payment fees. In these cases, the unrealistically short length of time available for full repayment is itself a contributor to default, and therefore leads to the extraction of further fees from the borrower. In the UK the payday lenders also exploited borrowers through the repeat use of 'Continuous

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Payment Authority'. This allowed them to make repeated attempts to recover payments from defaulting borrowers' bank accounts; charging high fees on each occasion[4].

Finally, usury also occurs when loan products are 'rolled over' or refinanced. In the face of over-indebtedness, the lender traps the debtor between default (resulting in greater fees and loss of future access to credit) and refinancing: offering to reschedule the debt, albeit on usurious terms. Debtors are unlikely to refuse such offers due to the potential repercussions of insolvency[5]. The bank can offer a new interest rate, new products, instalments etc. with each rescheduling. The debtor accepts whatever new terms are offered because they consider there to be no practical alternative. Where the consequences for default are severe, then Bentham's condition of voluntary transactions for mutual benefit cannot be fulfilled.

2.2 Discrimination Through Risk-based Pricing

If a person is classified as a high risk without any economically justified risk factors, this constitutes non-economic or prejudicial discrimination (Becker 1957). Such discrimination can be maintained only as long as the lender is earning monopoly rents. If credit markets were competitive, market forces would push discriminating lenders out of business (Lindley et al. 1984, p. 736). There are risk factors that must be attributed to the borrower because only he or she can control them. The lender, however, has only imperfect (asymmetric) information about their credit applicants, so that risk-based pricing relies solely on observable risk factors for *groups* of borrowers, classified, for example, according to the level of their income or assets[6].

This assumes that the mere fact that someone has a low income makes them a high risk. However, poverty is not a behaviour, but a social condition. The main trigger of insolvency or over-indebtedness is not poverty, but the occurrence of exogenous shocks such as unemployment, reduced income, illness, accidents or rises in the cost of living (Ulbricht 2018, pp. 8, Banque de France 2014, ASB Schuldnerberatungen 2019, Civic Consulting 2013). In a well-functioning credit market, these systemic or macroeconomic risks would be shared by all borrowers rather than the poor alone, which would increase the capacity of the whole economy to bear risks. Social discrimination through risk-based pricing reduces welfare by narrowing down macroeconomic risk-sharing (Reifner 2017a, pp. 75).

This systemic failure involves a self-fulfilling prophecy: with low income households charged more due to risk-based pricing, their liquidity decreases so that the default risk rises. In this sense, the cost of credit is an endogenous variable in its own credit default risk. The likelihood of default rises as a result of usurious interest rates and practices. This is supported by empirical literature (e.g. Ards et al. 2015). In the US business loan market, minority business owners have higher rates of

4 Steps to address this problem were taken by the UK's Financial Conduct Authority in July 2014 when the number of unsuccessful attempts to obtain funds through the use of Continuous Payment Authority were limited to two. For further details, see https://www.fca.org.uk/news/news-stories/tougher-rules-payday-lenders-take-effect.

5 It should be noted that the prevailing insolvency framework therefore has an influence on the debtor's decision-making. Insolvency frameworks which provide for the swift eradication of liabilities, and for the rehabilitation of credit scores within a reasonable period, may reduce the pressure on over-indebted households to continually refinance their debts on usurious terms.

6 So-called third-degree price discrimination or group-pricing, which increases a monopolist's profits (Belleflame and Peitz 2015, pp. 198).

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payment delinquency than would be predicted by forward-looking credit score models, which may be explained by the fact that they have to pay higher interest rates or are able to access less credit, which limits their ability to withstand unfavorable shocks (Robb and Robinson 2018). Also, in U.S mortgage markets, there are large racial and ethnic differences in loan rates, even after controlling for detailed borrower and loan attributes. These may have important implications for the dynamics of social discrimination related to wealth, credit-worthiness and homeownership, exacerbating existing wealth gaps (Bayer et al. 2018). Mortgage borrowers in predominantly black neighborhoods pay a significantly higher loan rate than is consistent with evidence as to their behavior (Kau et al. 2012).

2.3 Negative Externalities

A further justification for usury limits lies with the problem of negative externalities. Credit markets may fail because (even mutually beneficial) transactions affect third parties who bear costs without benefitting from the exchange.

Inadequately regulated credit markets may produce two kinds of externalities:

- First, excessive risk-taking by lenders may harm the public at large and taxpayers in particular, who are likely to bear the costs through higher taxes (Posner 1985). Whilst evidence about whether this specifically applies to consumer credit markets such as payday lending is inconsistent (Caskey 2010, Melzer 2011, Morse 2011, Mayer 2013, p. 525), several post financial crisis studies[7] have identified an unconditional correlation between high overall household debt levels and reduced economic growth after a three year time lag. Studies have also found that there are negative impacts even during the period of the "credit boom"; which can lead to a misallocation of resources and constrain productivity. In addition, there is widespread evidence that the social consequences of over-indebtedness (e. g. relationship breakdown, mental anïd physical health problems, increased homelessness etc.) present a considerable cost to public services[8].
- Secondly, deregulated pricing can lead to a cross-subsidization of those who default by those who do not default within a group of non-price sensitive consumers. In the absence of usury ceilings there is no limit on the level of default risk that creditors can take, and in non-price sensitive consumer credit markets such as payday lending creditors can recover losses on bad debts by charging other borrowers within the group very high prices. The more solvent majority of borrowers are effectively taxed to cover the greater losses of lending to few borrowers with high-risk. They subsidise this risk, which increases not only their borrowing costs, but also their own default risk. "That is neither fair nor desirable. A fee cap imposed at the minimum feasible level in this market ends this cross-subsidy and would almost certainly enhance aggregate well-being. If a few lose access to the product, many more benefit from the reduction in price" (Mayer 2013, p. 525). Analogously, Coco and de Meza (2009) argue that although it curbs lending, a suitable usury law enhances efficiency. In the presence of moral hazard, it always creates a net gain in redistributing income from lenders to borrowers. The efficiency gain is even stronger in the case of equilibrium credit rationing.

7 Reviewed in Lombardi et al. (2017).

8 For example, in the UK, the debt advice charity StepChange estimated the wider social costs of debt problems to cost around £ 8.3 billion in 2014: StepChange (2014). 'The £ 8.3bn challenge: the social cost of problem debt in the UK.'

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Empirical literature shows that the higher interest rates found in deregulated consumer credit markets result in increased probabilities of default (Li et al. 2012). Effective usury caps reduce interest rates without reducing the total credit availability. While a few who are the riskiest borrowers tend to lose access to loans, the great majority who still get loans pay substantially lower prices and are potentially able to borrow more. "These findings suggest that laws to lower fee limits up to some point would be beneficial to consumers, whose demand for these loans is price inelastic" (Avery and Samolyk 2011, p. 31).

2.4 Imperfect Information Provided to Consumers

Lack of, or imperfect, information provided to consumers has been identified as another possible cause of market failure. The corollary argument is that consumers may also lack the financial knowledge and skills to make the most optimal decisions when considering the information available to them. For some, more, and possibly better, information disclosure may therefore improve consumer decision-making and obviate the need for the imposition of usury ceilings (Bertrand and Morse 2011, Mayer 2013, p. 523).

However, neither increasing the amount of information provided to consumers, nor the extension of financial literacy programmes is likely to address the problem of *systemic* usury in consumer credit markets. Even fully informed, perfectly knowledgeable, and financially adept consumers can still become trapped in a situation of social discrimination. To protect borrowers from usurious exploitation, it is not sufficient to provide information at the time the contract is concluded. Even perfect financial knowledge would not help those whose alternative courses of action are arbitrarily limited. In the above model of a bilateral monopoly, more information may strengthen the bargaining power of consumers, but would not solve their problem of hold-up.

It is also notable that if financial literacy levels did, in fact, reduce default risk then we would expect to see lenders innovating to reflect these within their credit scoring systems. However, there is no evidence of any such innovation taking place. This is likely to be because lenders recognise that levels of financial literacy do not make any significant difference to the *propensity* of income shocks – such as unemployment or the onset of illness – which underpin the vast majority of defaults.

It is also clear that no borrower can hold perfect information about 'the future' (i. e. the likelihood or severity of those events which often give rise to debt problems and defaults). Further to this, theories of life-cycle consumption and permanent income hypothesis (going back to Modigliani and Brumberg 1954 and Friedman 1957), which rely on such perfect and rational future knowledge are undermined by the increasing complexity and uncertainty of modern labour markets, whilst the increasingly insecure employment that has resulted from the erosion of labour market protections in recent decades combines with reduced welfare state provision to make defaults more likely and increase overall risk levels. Although borrowers with good financial management skills may be able to budget effectively when they are employed, this doesn't reduce the risk of their becoming unemployed. Financial literacy may increase precautionary savings levels, but these are upper limit bound by disposable incomes.

Regulators are finally accepting the limits of information disclosure and financial literacy programmes. For example, a recent report examining the effectiveness of disclosure remedies in Australia, the Netherlands, the UK and the US, identifies that reliance on such interventions has often proved ineffective, and in some instances even backfired: contributing to more consumer harm (e. g. by increasing rather than decreasing trust in conflicted advisers, and decreasing rather than increasing credit card repayments (ASCI-AFM 2019).

3 Evaluation of Directive 2008/48/EC with Regard to the Spread of Usurious Credit in Europe

3.1 Background to the Directive and its Relationship to Usury

The Consumer Credit Directive 2008 replaced its 1987 predecessor, which was itself one of the first attempts to develop a regulatory framework based on something other than an ultra-libertarian, free-market approach. Although the 1987 Directive unified national information and disclosure requirements (using the Anglo-American regulations as its basis) it also provided some substantive consumer protections, including the right to redress from the lender in the event that goods or services bought on credit were not satisfactorily supplied. The Directive also banned certain practices which prevented consumers from enforcing their rights. Importantly, the 1987 Directive also took a 'minimum harmonisation' approach: leaving national legislatures free to improve consumer protection to higher standards.

In 2002, a new draft of a Consumer Credit Directive, developed with consumer and academic input and supported by scientific research, continued on this path. This expressly dedicated itself to the prevention of over-indebtedness and the further development of consumer protection. This draft proposed several actions to address the emerging problems of payment protection insurance; refinancing and 'chain credit', and the high levels of over-indebtedness identified in many Member States at the time. The initial 2002 draft of the Directive also took care to require good standards of behaviour from lenders, by imposing a principle of 'responsible lending'. However, this initial new draft of the EU-Commission was rejected by both the European Parliament and the EU-Commission.

A further attempt to update the Consumer Credit Directive was then made in 2004 and this eventually led to the current 2008 Directive. Although the 2004 draft claimed to merely seek an adaptation to the information and disclosure requirements of the 1987 Directive, it was, in fact, designed to undermine national anti-usury protections. It achieved this by redefining, through 'total harmonisation', the previously developed civil law concepts of 'credit', 'interest', 'fees' etc. on which national debtor protections had been built. At its heart, the new Directive promoted the notion that consumers, once provided with the necessary information and time to reflect on offers of credit, do not require any additional protections against usurious products and practices. In its Post-Financial-Services-Action plans the Commission even stated its intention to abolish national usury ceilings, which it viewed as detrimental to the creation of a cost-effective common market.

The 2008 Directive implies that the terms of any credit or loan meeting its requirements is acceptable. As a consequence, it undermines the national fight against usury and erodes its foundations. It does this not only through its over-emphasis on imperfect information as the cause of problems in consumer credit markets but, as we now proceed to explain, by redefining key terms, such as 'interest', contained in national legislation. The 2008 Directive also rejected the 2002 proposal to impose 'responsible lending' requirements; replacing these with an obligation on lenders to assess the 'creditworthiness' of borrowers through the use of credit reference data. In this way, the Directive hardwires the practice of risk-based pricing into European credit markets.

3.2 Arbitrary Definitions of 'Interest'

The Directive contains at least four different and inconsistent definitions of the term 'interest' and the term appears to be used arbitrarily: giving suppliers far too much discretion to adapt its definition(s) to suit their needs.

Because of the contradicting definitions provided, the Directive does not even achieve its own stated objectives regarding an improvement in levels of transparency and information for consumers. However, it also has severe repercussions for the effectiveness of national usury legislation. This is because the term has been redefined to exclude some elements of the total cost that borrowers pay. Consumers need to be given information on an APRC (annual percentage rate of charge) which represents all the payments they are required to make during the course of their credit agreement. However, the Directive allows lenders to omit the cost of, for example, PPI premiums from their APRC calculations, resulting in a figure which, in many cases, reflects less than 50 % of the actual overall cost of credit.

The assumption that providing consumers with more and more information is a possible cure for the problems of exploitation and over-indebtedness has also led to an information overload: where up to twenty pages of fine print for each product filled with inconsistent information hinder the understanding of agreements even for specialists. Usury assessment by credit advisors and courts has become nearly impossible.

3.3 Lack of a Consistent Payment Plan

In addition to the failure to define 'interest' consistently (and correctly), the Directive also fails to require lenders to provide a consistent payment plan to borrowers. In its place, the Directive substitutes the provision of an 'amortization table' (Art. 10 (2) (i)). Again, this is arbitrarily calculated, and it is also only required to be provided to borrowers on request and after the conclusion of the contract.

This requirement is inadequate to deal with the problems caused by the growth in refinancing, and the spread of 'chain credit contracts' in which interest is artificially turned into interest bearing capital. In those chain contracts, usurious new contracts are imposed on defaulting consumers.

It should be noted that Art. 16 of the Directive governing early repayment is also used in a way which exploits borrowers: providing for creditors to obtain 'compensation' if a debt is repaid early.

3.4 Total Harmonisation

Recital 9 of the Directive explains that "Full harmonisation is necessary in order to ensure that all consumers in the Community enjoy a high and equivalent level of protection of their interests and to create a genuine internal market. Member States should therefore not be allowed to maintain or introduce national provisions other than those laid down in this Directive."

National legislatures are therefore required to allow lenders to define key terms such as interest in line with the Directive. Full harmonisation has therefore undermined national protections across Europe and caused the most vulnerable to be harmed by usurious credit practices.

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3.5 Evaluation of the 2008 Directive

The 2008 Directive provided an early opportunity to respond to the emerging global financial crisis at the time, and by the time of its implementation (May 2010) it was already looking outmoded. Looking back now, the need for reform is even clearer.

Reform of the Directive should draw on the lessons learnt from the crisis: expressed especially by the ten G20 high level principles on Financial Consumer Protection (OECD 2011)[9] and the seven ECRC Principles of Responsible Credit (ECRC 2014).[10] There is much reason to believe that the "subprime" (i.e. usurious) crisis was due to irresponsible credit card and instalment credit lending in the US, refinanced by a delimited mortgage market whose bad debt and its cost were sold to foreign investors (Reifner 2017b).

The final version of the Directive omitted consumer protection and the prevention of over-indebtedness from its goals. This was in contrast with the original draft. In Art. 1 only "legal harmonisation" was left as "the purpose of this Directive". This seemingly justified its "imperative nature" (Art. 22), but was in spite of surveys mandated by the Commission which showing no great appetite (amongst either lenders or consumers) for the development of cross border consumer credit markets (Reifner et al. 2006). The only responses indicating such a need were received from small banks located in Luxembourg and Switzerland. It is our view that those institutions are trying to escape effective supervision in order to maintain usurious lending practices. Whilst recital 9 of the Directive states that substantive national consumer and debtor protections remained unaffected, the fact that definitions of key contract terms are open to one-sided manipulation frees those who have the power to do so from traditional legal restrictions.[11] Choice is supposed to replace rights. Exploitation, usurious practices and the systemic misuse of lender power with regard to borrowers in difficult social situations are now indirectly accepted through EU-law.

The view in most Member States seems to have been that the Directive does not explicitly sanction usury. This is because its rules are not applicable if a consumer is deemed to have chosen ("not compulsory" Art. 3 (g)) a transparent product. However, provided that the consumer was given the required information prior to entering a contract, any number of usurious practices are possible. These include high cost and forced refinancing, PPI premiums, incorrect interest rate calculations, anatocism, chain contracts, flipping and churning as well as the deviation of credit repayments into investment products with negative return. All are implicitly sanctioned so long as the consumer was given the required information.

With its requirement for total harmonisation the Directive especially discriminates against poor people and breaks the EU Commission's stated commitment to a high level of consumer pro-

9 Principle 3 requires: 'All financial consumers should be treated equitably, honestly and fairly at all stages of their relationship with financial service providers. [...] Special attention should be dedicated to the needs of vulnerable groups" (OECD 2011, p. 5).

10 Principle 3 reads: *"Lending has at all times to be cautious, responsible and fair. a) Credit and its servicing must be productive for the borrower. b) Responsible lending requires the provision of all necessary information and advice to consumers and liability for missing and incorrect information. c) No lender should be allowed to exploit the weakness, need or naivety of borrowers. d) Early repayment, without penalty, must be possible. e) The conditions under which consumers can refinance or reschedule their debt should be regulated." (ECRC 2014)) For a review of Responsible Credit in European Law see Reifner (2018).*

11 For an overview see Reifner and Schroeder (2012).

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tection. To tackle this issue we recommend observing the principle laid out in Art. 3 (3) EU-Treaty and return to the use of the minimum harmonisation principle set out in Art. 169 (4). This requires that *measures adopted pursuant to paragraph 3 shall not prevent any Member State from maintaining or introducing more stringent protective measures*. In this respect Art. 41 Directive 2014/17/EU (MCD) for mortgage credit should be copied into the Consumer Credit Directive as it avoids the circumvention of protective rules.

In any event, the Directives (consumer credit and mortgage credit) ought to be merged as they were in the initial 2002 Draft, because the artificial separation of consumer credit into two different legal bodies leads to additional difficulty in the harmonisation of national law.

3.6 Usurious Credit in Practice

Instead of listing the numerous ways in which lenders are allowed to engage in usury, we now present a typical credit chain of a large international consumer credit bank, where the original contract taken out in September 2003 was refinanced six times through to October 2012.[12] Each of the subsequent contracts in the chain provided an opportunity for the bank to sell further PPI, which steadily increased to nearly five times its initial cost per month. This resulted in premiums much higher than would be payable for insurance products which were not linked to the credit agreement (see Figures 1 and 2). At each refinancing, the bank cancelled the ongoing insurance contract and concluded a new one, with ever growing, and usurious, premiums for basically the same risk.

The disclosed APRC of the contracts fluctuated between 15.76 % p.a. and 11.24 %. The mathematical definition in the annex of the Directive requires that all instalments paid by the consumer have to be calculated in relation to all payments made by the bank to him or her. If this had been done for the whole chain credit system neglecting the artificial separation into seven contracts as well as into separate credit and insurance contracts, the correct APRC for the whole relationship would have been 25.12 %.

The calculation allowed by the Directive therefore significantly underestimates the usurious burden that this borrower had to endure. These problems do not arise from ignorance on the part of the EU Commission. It commissioned empirical and mathematical research in 1998 to correctly understand the problems (Reifner et al, 1998) as part of its preparations for the 2002 draft Directive. However, the 2008 Directive neglected to act on this information. Action by the EU to address the usurious nature of PPI remains particularly baffling given that the ‘PPI scandal’ has been the subject of significant attention in the U.K[13].

12 Hundreds of similar contracts are on file at the credit advice centers in Germany in 2019. (see *www.StopWucher.de*).

13 See The Guardian Aug. 2, 2016: *PPI claims – all you need to know about the mis-selling scandal, https://www.theguardian.com/business/2016/aug/02/ppi-claims-all-you-need-to-know-about-the-mis-selling-scandal (27.05.2019).*

Figure 1

Cost of Payment Protection Insurance

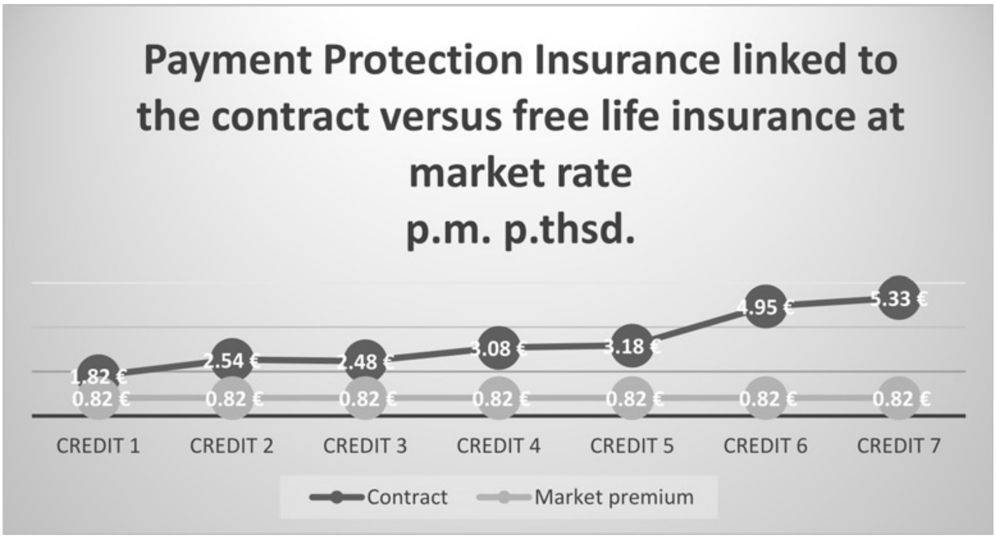
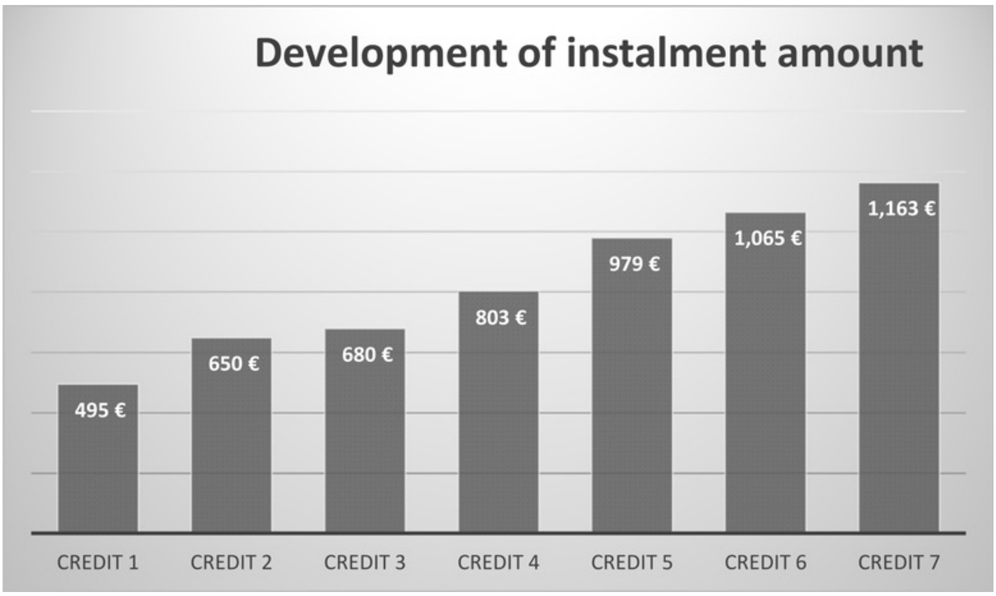


Figure 2

Instalment Payments in the Credit Chain



3.7 What Do Consumers Need?

Consumer credit provides access to future income. This can be used in a variety of ways. It can help consumers who do not have sufficient liquidity and savings to pay in advance for the purchase of desirable goods and services. It can also be used to bridge temporary liquidity crises (birth of children, illness, unemployment, education, etc.) and to raise capital for investment in the future (appliances, homes, education and training, etc.). It can help people take advantage of time-limited offers and opportunities.

But the precise level of utility of credit that consumers can derive from its use is heavily dependent on the cost that they pay for it. Consumers are required to select the cheapest credit (fair *competition*), which is best adapted to their foreseeable liquidity in the future (*responsible credit*). To achieve these goals, they must be protected from the exploitation of their hardships, poverty and needs by irresponsible loans offered in a profit-oriented market (*usury*).

The APRC plays a decisive role for all three functions. The Annex to the Directive refers to the APRC as the only mathematical and therefore correct means of presenting prices (*truth in lending*), which distributes costs evenly over the duration of the agreement with regard to the amount of the outstanding loan (*accessory principle*). As a result, it is capable of identifying where an interest rate is “grossly disproportionate” to average market prices (*usury*).

However, providing consumers with 20 pages of often repeated information and superfluous descriptions of rarely occurring marginal facts and situations does not provide the basis for a rational decision.

Instead, a consumer credit agreement should culminate in the information compiled through a comprehensive payment plan. This needs to show the amounts and times when credit is drawn down and the amounts and times of the repayments. This payment plan should be calculated on the basis of an inclusive APRC. It would prove that the APRC is correctly applied, that there are no additional charges and hidden costs and that the consumer has received the promised amount at the due date. This would allow consumers to identify the most important aspects of the agreement and avoid information overload.

However, the Directive (1) does not provide for a right to a pre-contractual payment plan, (2) the indicated APRC does not cover a substantial part of the due payments and (3) instead of the APRC an arbitrary “borrowing rate” (Art. 3 (k)) l is used to calculate the interest on the residual debt in case of early repayment.

4 Conclusions

Usury refers to the offer of a good or service for a significantly excessive price: one which takes advantage of the weak position of a contractual partner. Its prevention requires adequate regulation.

Regarding consumer credit markets, the German Coalition against Usury and the European Coalition for Responsible Credit (ECRC) have voiced their concern over the neglect of usurious practices in the European Consumer Credit Directive (CCD 2008). This paper has reviewed the economic rationale for usury legislation and evaluated the CCD 2008 in this context. It identifies systemic usury

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as a problem of social discrimination, where belonging to a group which is statistically discriminated against leads to entrapment in a chain of usurious credit and financial contracts. Systemic usury particularly affects low-income households and results from three market failures:

(1) Monopoly power in a bilateral credit relationship: consumers with weak bargaining power become trapped in inescapable relationships with their lenders. In a bilateral monopoly between a bank and a consumer on the threshold of insolvency, the bank may abuse its monopoly power by fixing the price-quantity offers. Such offers often include a costly rescheduling of loans and additional products such as payment protection insurance with high fees. Debtors are unlikely to refuse such offers due to the potential repercussions of insolvency.
(2) Discrimination through risk-based pricing: Groups of borrowers such as low income households are discriminated, because lenders consider them as a high risk, demanding higher interest rates, although this is not economically justified. The main trigger of insolvency is not poverty, but the occurrence of exogenous shocks such as unemployment, illness or rises in the cost of living. Social discrimination through risk-based pricing reduces welfare by narrowing down risk-sharing. Moreover, risk-based pricing is a self-fulfilling prophecy: the increased risk premium reduces liquidity, increasing the probability of insolvency. These dynamics of social discrimination are exacerbating existing income and wealth gaps.
(3) Negative externalities: (i) Excessive risk-taking by lenders in unregulated credit markets may harm the public at large by reducing economic growth and productivity. Besides that, the social consequences of over-indebtedness present a considerable cost to public services. (ii) Within a group of non-price sensitive consumers, lenders may cross-subsidize those who default by those who do not, implying that the more solvent majority of borrowers are effectively taxed to cover the greater losses of lending to a minority of high-risk borrowers. This again reduces economic efficiency.

These market failures cannot be addressed by increasing the amount of information provided to consumers at the point of contracting – a fallacy underlying the European Consumer Credit Directive. Its main idea was that those who get the necessary information would not at all need protection against usurious products and practices. As a consequence, the Directive is found to be ineffective: it implicitly acknowledges usurious practices and products as legal and undermines the national fight against usury.

The Consumer Credit Directive should be reformed. A new approach is needed, and the 2002 Draft of the EU-Commission, which proposed a consistent regulation to combat usury and prevent over-indebtedness, could provide an important basis for this.

However, two urgent reforms are also required. The first step should be the abolition of the imperative character of the 2008 Directive with regard to national law. This would allow the development of a more consistent, transparent and focused consumer credit law as it was in force in many countries before the 2008 Directive intervened.

Secondly, the wording of Art. 3g[14] of Directive 2008/48 currently excludes insurance premiums (and the cost of other ancillary services relating to credit agreements) from the total cost of the credit unless these services are "**compulsory** in order to obtain the credit or to obtain it on the terms and conditions marketed".

This exclusion of non-compulsory service costs should be ended. This could, for example, be done by changing the wording of Art. 3g back to the wording of Art. 12 (2) of the initial proposal COM(2002) 443 final of 11. 9. 2002 where the costs of ancillary services were included in the total credit costs if the services were contracted for "**when** the credit agreement is **concluded.**" This simple return to the draft 2002 requirement would revitalise national usury law. Its application could stop the misuse of Payment Protection Insurance for usurious credit.

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14 Reiterated in Art. 4 (3); 5 k); Annex II No 3 (3)

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