Introduction

MEL KENNY AND JAMES DEVENNEY

This collection of edited essays, along with a linked collection (*European Consumer Protection: Theory and Practice* (Cambridge, 2011)), emanates from a duo-colloquium – *Consumer Protection in Europe: Theory and Practice* – hosted by the Centre for European Law and Legal Studies at Leeds University, in association with the Institute of Commercial and Corporate Law at Durham University, in December 2009. That conference explored consumer protection in Europe in the context of the then proposed Consumer Rights Directive,[1] efforts to consolidate the *consumer acquis*[2] and the draft Common Frame of Reference[3] – topics which are even more relevant today given, for example, the passage of the Consumer Rights Directive, the Commission's appointment of an Expert Group on a Common Frame of Reference in the area of European contract law,[4] the Commission Green Paper on policy options for progress towards a European Contract Law for consumers and businesses,[5] and the proposed Common European Sales Law.

The conference was the second in a series of events organised within the work programme *Credit and Debt: Protecting the Vulnerable in Europe*, a project placing special emphasis on vulnerability in financial transactions and then based at the Centre for Law and Legal Studies at Leeds Law School. In keeping with one of the major themes of that project, this collection focuses on the specific issue of European

[1] Available at: http://ec.europa.eu/consumers/rights/docs/COMM_PDF_COM_2008_0614_F_EN_PROPOSITION_DE_DIRECTIVE.pdf.
[2] On which see, for example, B. Heiderhoff and M. Kenny, 'The Commission's 2007 Green Paper on the Consumer Acquis: Deliberate Deliberation?', 32 (2007), 740.
[3] See C. von Bar and E. Clive, *Principles, Definitions and Model Rules of European Private Law: Draft Common Frame of Reference (DCFR)* (Oxford: Oxford University Press, 2010).
[4] See Commission Decision 2010/233/EU; 2010 OJ L 105/109.
[5] See European Commission, 'Green Paper from the Comission on Policy Options for Progress towards a European Contract Law for Consumers and Businesses', COM (2010) 348 final.

consumer protection in the context of credit and investments. The backdrop to the chapters in this collection is, of course, the recent unprecedented turmoil in credit and investment markets, and EU harmonisation initiatives in the area (e.g. the most recent Consumer Credit Directive). The collection deals with key issues such as responsible lending, information disclosure, consumer confidence, the regulation of consumer investment services (with special emphasis on investor rights) and the protection of bank depositors. In so doing, intriguing insights on aspects of consumer protection in individual Member States are offered.

The *Credit and Debt: Protecting the Vulnerable in Europe* project owes its genesis to work originally organised under the umbrella of the Commission's Sixth Framework Programme (FP6) on the protection of vulnerable family sureties. This was an ambitious Transfer of Knowledge project, based at the Centre for Law and Politics at Bremen University and was coordinated by Professor Aurelia Colombi Ciacchi, then at the Centre for Law and Politics at Bremen University, and Professor Stephen Weatherill at the Institute of European and Comparative Law at Oxford. It was only logical to develop some of the ideas which can be traced to that original research in Bremen – with the valuable collaboration of Professors Gert Brüggemeier (Bremen), Gerard McCormack (Leeds) and Sjef van Erp (Maastricht) – in this project.

This collection, and the conference from which it emanates, would not have been possible without the generous support it has received from Marie Curie research funds through the European Commission (European Reintegration Grant 223605) within the Seventh Framework Programme (FP7). In Brussels we are grateful to the assistance and support of Pascale Dupont, Chantal Huts and Laurent Correia, our FP7 project officers. We are also indebted at an institutional and material level to the Institute of Corporate and Commercial Law at Durham and to the Centre of European Law and Legal Studies at Leeds. In this regard our special thanks are due to Professor Dagmar Schiek at the Centre for European Law and Legal Studies for her support of this event.

We are also indebted to all those who submitted proposals, held papers, chaired sessions and made contributions to the conference and to this volume. In particular we are grateful to Professor Peter Rott (Copenhagen), Dr Vanessa Mak (Tilburg), Dr Cristina Poncibò (Turin), Professor Axel Halfmeier (Frankfurt), Bastian Schüller (Oslo), Professor Immaculada Barral Vinals (Barcelona), Dr Amandine Garde (Durham), Alan Littler (Tilburg), Dr Orkun Akseli (Durham), Dr Paul Wragg

(Leeds), Dr Monika Jagielska and Dr Mariusz Jagielski (Katowice), Dr David Pearce (Leeds), Dr Lorna Gillies (Leicester), Christopher Bisping (Leicester), Professor Roger Halson (Leeds), Dr Warren Swain (Queensland), Professor Chris Willett (Essex), Martin Morgan-Taylor (De Montfort), Blanka Tomančáková (Palacky), Dr Christine Riefa (Brunel), Catherine Garcia Porras and Professor Willem van Boom (Rotterdam), Sarah Nield (Southampton), Karen Fairweather (Queensland), Professor Andrew Keay (Leeds), Dr Sarah Brown (Leeds), Marine Friant-Perrot (Nantes), Dr Rodica Diana Apan (Baia Mare), Professor Geraint Howells (Manchester), Howard Johnson (Cardiff), Dr Olha Cherednychenko (Groningen), Professor Cristina Amato and Dr Chiara Perfumi (Brescia) and Professor Andrew Campbell (Leeds).

Any conference and any project relies on the cooperation and dedication of many otherwise unsung members of the support staff. We would like to take the opportunity to thank Lindsey Hill, Karen Houkes and Amanda Hemingway at Leeds Law School for their patience and help. We would also like to thank Susan Lacey, Harriet Boatwright and John Gibson at University of Leeds, Conference and Events, for the highly professional delivery of a truly memorable event. We are also grateful for the assistance provided by a small team of postgraduates and undergraduates in Leeds who assisted in all aspects of conference organisation and in compiling the conference report: Anna Dachowska, Sacha Wooldridge, Ourania Vrondou, Bijan Varahram, Sophie Leslie, Sophie Hobson, Alexandra Weatherdon, Naeem Hirani, Andrew Vernon, Erica Robinson and Abigail Webb deserve our particular thanks. Crucial support has also been given by the highly dedicated staff at Cambridge University Press; in particular we would like to thank Kim Hughes, Sarah Roberts, Richard Woodham, Daniel Dunlavey and Finola O'Sullivan for their ongoing support and efficient management of the production process. Editorial assistance to the project was enthusiastically delivered by Claire Devenney.

Since the organisation of this conference and the preparation of this collection, we have both moved to new pastures: Mel to a Chair at De Montfort and James to a Chair in Commercial Law at Exeter. Information on the ongoing work and forthcoming events under the project can be obtained from the editors.

This collection is dedicated to our parents.

Marie Curie Credit and Debt Project: FP7 ERG 223605

1

Vulnerability and access to low cost credit

ORKUN AKSELI

1 Introduction

Access to low cost credit is at the crossroads of contracts, property, company and consumer laws. Thus it has many directions which may interact with the concept of vulnerability. Access to credit is critical for consumers, small and medium sized enterprises (SMEs) and large companies. Risks have been revealed through the abusive use of financing techniques such as securitisation. This has been coupled with the poor perception of the risks involved in innovative techniques of raising finance, including failure properly to explain risks to investors. This has led to increasing indebtedness and loss of investor confidence. Similar arguments apply to consumers whose confidence has been affected by irresponsible lending practices that turned the subprime crisis into a global financial crisis. Lack of access to funds reveals susceptibility to loss of business for SMEs and lack of access to the housing market for consumers. The Bank of England's current interest rate (0.5 per cent)[1] has not been reflected in the interest rates of banks which have kept their interest rates at a higher level and refused to lend to businesses.[2]

In March 2009, the Bank of England, while reducing the interest rate to 0.5 per cent, employed a method known as Quantitative Easing (QE). Essentially, QE is a monetary policy according to which the Bank of England channels credit into the economy and banks to help particularly banks to build up their reserves and to lend to borrowers. QE also enables the Government to meet the inflation target and avoids stagnation by increasing economic activity and growth. During times of

Durham University Law School, England.

[1] www.bankofengland.co.uk/ (last accessed 9 March 2010). The current official Bank of England interest rate was set on 5 March 2009. It is worth noting that the Bank of England rate is reviewed every month.

[2] P. Moores, 'Credit Strike Highlights Need for Reform', *Financial Times*, 15 February 2009.

financial crisis central banks may purchase private sector debt to assist corporate credit markets to be relieved.[3] This assists companies to continue to lend and reduce the cost of credit by giving confidence to investors. However, injection of money into the economy has to stop at a certain point in order to meet the inflation target, because too much money in the market will trigger high inflation.[4]

This chapter will focus on exploring the meaning of vulnerability in the context of SMEs' access to credit. It also examines the possible effects of lack of access to finance on SMEs and offers some suggestions on financing SMEs in order to overcome difficulties in access to finance through modernisation of law in this area. The recurrent theme is that, unlike for most large businesses, access to low cost credit is critical for SMEs, since financiers and banks only extend credit to SMEs on a secured basis, thus often applying high interest rates in which they include default risk, so increasing the cost of credit. SMEs that fail to gain access to low cost credit become susceptible against creditors and may be prone to insolvency. Inability to access finance constitutes vulnerability for SMEs, who need liquidity to expand their operations.

Section 2 will discuss briefly the background of credit crisis and reasons for lack of access to finance. In that context, the focus will be on the reasons for SMEs' difficulties in access to credit. Section 3 will explore the definition of vulnerability to the extent it interacts with access to low cost credit. Section 4 will examine some policy issues and suggest some solutions drawn from modernisation activities of law of credit and security. Conclusions will be in Section 5.

[3] For a recent example see 'Quantitative Easing: What Is It, Will It Work and What Are the Alternatives?', *Guardian*, 7 October 2011, according to which the Federal Reserve purchased mortgage-backed securities and corporate bonds to ease the flow of credit.

[4] For further information on quantitative easing see Bank of England, 'Quantitative Easing Explained: Putting More Money in to Our Economy to Boost Spending', available at www.bankofengland.co.uk/monetarypolicy/pdf/qe-pamphlet.pdf (last accessed 10 March 2011). It is possible that a third round of QE may be employed. See www.guardian.co.uk/business/2011/oct/09/third-round-quantitative-easing-possible (last accessed 10 October 2011). In the first week of February 2010, the Bank of England announced that QE would halt as, despite injection of critical amounts of money into the economy, the inflation rate did not drop below 2 per cent and bank lending had not been affected. 'The Bank of England Is Right to Halt its Injection of Huge Sums into the Economy', *The Times*, 5 February 2010. But cf. www.guardian.co.uk/business/2011/oct/09/third-round-quanititative-easing-possible (last accessed 10 October 2011).

2 Credit crisis and lack of access to finance

The increased level of lending to borrowers with poor credit histories in the USA can be regarded as the starting point of the so-called 'credit crunch'. The credit crisis,[5] which has its roots in the subprime mortgage crisis in the USA, has affected lending practices of banks after rescues and bail-outs. It is arguable that when the Glass-Steagall Act,[6] that separated commercial and investment banks, was repealed in 1999 by the Gramm-Leach-Bliley Act (the Financial Modernization Act 1999),[7] which allowed the consolidation of commercial and investment banks, the working method of investment banks (i.e. investment and selling bonds and equities by taking high risk) was introduced to commercial high street banks (which only lend money on a much lower scale than the investment banks do). Arguably this encouraged commercial high street banks to lend under risky circumstances. A similar argument applies to investment banks and hedge funds which assumed debt burdens but were not regulated like high street banks. This may have contributed to the global financial crisis.[8] Owing to a lack of meaningful

[5] For a detailed analysis of the credit crisis, its relationship to the subprime mortgage crisis in the USA and suggestions for recovery, see e.g. S. Schwarcz, 'Understanding the Subprime Financial Crisis', *South Carolina Law Review* 60 (2009), 549–72; S. Schwarcz, 'Disclosure's Failure in the Subprime Mortgage Crisis', *American Law and Economics Association Annual Meetings* Working Paper no. 18 (2008); O. Bar-Gill, 'The Law, Economics and Psychology of Subprime Mortgage Contracts', *Cornell Law Review* 94 (2009), 1073–1152.

[6] This is officially known as The Banking Act of 1933. The Act created the Federal Deposit Insurance Corporation (FDIC) in 1933. See also www.fdic.gov/about/learn/symbol/index.html (last accessed 11 March 2010).

[7] See www.gpo.gov/fdsys/pkg/PLAW-106publ102/pdf/PLAW-106publ102.pdf (last accessed 11 March 2010).

[8] For the implications of repealing the Glass-Steagall Act and an interesting background and criticism of these legislative activities, see e.g. J. Stiglitz, 'Capitalist Fools', *Vanity Fair*, January 2009. It is important to note that recently in the USA the Obama administration has proposed the breaking up of banks and limiting their overall size and functions (such as prohibiting them from dealing with hedge funds, proprietary trade and private equity). See R. Peston, 'Obama to Break Up Banks', available at www.bbc.co.uk/blogs/thereporters/robertpeston/2010/01/obama_to_break_up_banks.html (last accessed 12 March 2010). Similar arguments equally apply in the UK. The Conservative Party banking reform paper also suggests similar solutions. See generally 'From Crisis to Confidence: Plan for Sound Banking', Policy White Paper (July 2009). In October 2009, the Bank of England's Governor Mervyn King also suggested restructuring of banks in addition to regulating them. See also R. Peston, 'Bank of England Backs "Spirit of Obama's Reforms"', available at www.bbc.co.uk/blogs/thereporters/robertpeston/2010/01/bank_of_england_backs_spirit_o.html (last accessed 10 March 2010).

regulation of investment banks and other financial institutions, the necessary capital requirements critical to shield the banks against defaults have been avoided. Normally, Basel II requirements urge banks to clarify and make transparent their supervision and legal structures in order to support credit and security.[9] The subprime lending practices, which involved lending to individuals (subprime borrowers)[10] who posed credit risk with weak or poor credit histories,[11] were coupled with subprime mortgage securitisations, where competition among loan originators and among securitisers played a significant role in the lead up to the crisis.[12] Thus the risk involved in the lending and repayment of these borrowed amounts to financial institutions was transferred to investors who purchased securitised debts. The crisis which started as a subprime mortgage crisis turned into a global financial crisis by the globalised nature of financial markets where investors from different countries and markets purchased financial products which were the products of securitised subprime mortgages. It could be argued that the credit lent to borrowers with poor credit histories was a risky business decision. This was later securitised as mortgage-based securities to raise finance for banks. Because of the nature of securitisation,[13] there

[9] K. Alexander, 'Global Financial Standards Setting, the G10 Committees and International Economic Law', *Brooklyn Journal of International Law* 34 (2009), 861–81. For some criticism and suggestions for reform to financial supervision, see G. Caprio Jr., A. Demirguc-Kunt and E. J. Kane, 'The 2007 Meltdown in Structured Securitization: Searching for Lessons, Not Scapegoats', Policy Research Working Paper 4756 (2008). It is also interesting to note that the new Basel III standards on liquidity, which require banks to hold more liquidity in order to be more resilient to further credit crises, are being relaxed in order to facilitate lending to consumers and businesses. See 'Regulators Poised to Soften New Bank Rules', *Financial Times*, 6 September 2011.

[10] In practice, subprime borrowers are those whose FICO (Fair Isaac Corporation) scores are below 620. See www.fico.com/en/Products/Scoring/Pages/FICO-Score.aspx (last accessed 12 March 2010); see also Bar-Gill, 'The Law, Economics and Psychology', at 1087.

[11] As early as 2001, FDIC released extended guidance in relation to subprime lending practices. The FDIC indicated a non-exhaustive list of credit risk characteristics posed by subprime borrowers. These include two or more 30-day delinquencies in the last 12 months, judgment, foreclosure or repossession in the last 24 months, bankruptcy in the last 5 years, relatively high default probability evidenced by credit history score, and imbalanced debt service-to-income ratio. Available at www.fdic.gov/news/news/press/2001/pr0901a.html (last accessed 11 March 2010).

[12] For an interesting discussion, see Bar-Gill, 'The Law, Economics and Psychology', 1087 *et seq.*

[13] Securitisation is, in fact, a simple method of raising finance based on the assignment of receivables expected to be generated from future rights to payment. In securitisation, receivables are collected, pooled and outright assigned to a company (SPV–Special

was lack of transparency, which may be understood as the lack of information or misinformation of investors, who purchased securities from Special Purpose Vehicles (SPVs), concerning the structure and the risks involved in those securities.[14] It is arguable that the complex nature of securitisation and various mortgage products, which had not been fully understood by investors and consumers, set the basis of vulnerability. Unreasonable risk was passed through securitisation to investors who were unaware of the risks involved. The decline of house prices and the market in the USA and defaults of borrowers with poor credit histories in repaying mortgages led to repossession of houses by banks. These risk-associated elements have been arguably ignored.[15] As the right to payment from risky borrowers was securitised, thus creating mortgage-based securitisation, upon maturity of securities, investors could not be repaid and they were left in a vulnerable position. The subprime mortgage crisis thus led to a global credit crisis when banks began defaulting in their payments to each other. This prompted larger banks to restrict their lending to smaller banks, building societies, SMEs and individuals as consumers.[16]

Purpose Vehicle) specially created and bankruptcy-remote from the assignor. The SPV issues securities or commercial paper to investors, which are secured on the receivables to raise finance in order to purchase the receivables. The originator/assignor continues to collect the receivables on behalf of the assignee. There may be an asset-backed securitisation, according to which the securities created are backed by pooled assets (e.g. credit card receivables), which are collateralised and cannot be sold individually as they are so small or illiquid, or by mortgage-backed securitisation according to which the securities created are backed by mortgage loans, lent to mortgage borrowers (either prime or subprime borrowers). On securitisation, see e.g. J. J. de Vries Robbe, *Securitization Law and Practice in the Face of the Credit Crunch* (Alphen aan den Rijn: Kluwer, 2008).

[14] For transparency recommendations and an implementation report of the International Organisation of Securities Commissions' (IOSCO) Task Force on Unregulated Financial Markets and Products, see www.iosco.org/ and 'Unregulated Financial Markets and Products – Final Report', *Technical Committee of the International Organization of Securities Commissions* (September 2009).

[15] See generally P. Krugman, 'How Did Economists Get It So Wrong?', *New York Times*, 6 September 2009.

[16] Arguably Northern Rock has had difficulties in obtaining funding from larger banks since the subprime mortgage crisis because little money has been available in the money markets. The BBC Business Editor Robert Peston explains this succinctly as follows: '[Northern Rock was] much more exposed than its rivals to this distaste for mortgage debt, because its business is overwhelmingly focused on providing mortgages, rather than other kinds of banking business.' See http://news.bbc.co.uk/1/hi/business/6994160.stm (last accessed 12 March 2010).

It could be argued that the rating agencies were also to blame for the lack of transparency. One commentator succinctly explained the rating agencies' involvement as follows:

> reckless speculation in real estate, overly leveraged financial institutions with too little equity capital, the [abusive] securitisation of mortgages and other financial instruments with insufficient understanding of the risks involved, and many other factors all contributed to the current financial meltdown.[17]

It can thus be argued that there were two stages in the financial crisis. The first stage was the lead up to the credit crisis (i.e. risky lending decisions to people with poor credit histories). The second stage was the result of the first one, causing financial institutions to limit severely their flow of credit, thus unjustly reflecting their fault on the consumers and SMEs. In other words, financial institutions were now being extra cautious to the detriment of small and medium sized borrowers. Their concerns were understandable; however, the crisis was not caused by consumers or the SMEs. The severe limitation of access to credit arguably caused the economy of the UK to shrink.

However, there are certain matters which cause concern on both parties (banks and SMEs) to a credit transaction. These include lack of transparency and predictability in credit and security law, a conservative approach to reform in security interests and lack of proper supervision on credit transactions. These, one way or another, contribute to vulnerability in accessing affordable credit.

3 Defining 'vulnerability' within the framework of access to low cost credit

The particular point in vulnerability and access to low cost credit is defining and conceptualising the term 'vulnerability'. The term, by itself, is multifaceted and used in diverse areas of law such as vulnerability in criminal law or vulnerability in consumer and contract law.[18] Within the

[17] T. Hurst, 'The Role of Credit Rating Agencies in the Current Worldwide Financial Crisis', *Company Lawyer* 61 (2009), 61–4. On problems with regard to predatory lending and its effect on consumers and the role of rating agencies in subprime mortgage crisis, see D. Reiss, 'Subprime Standardization: How Rating Agencies Allow Predatory Lending to Flourish in the Secondary Mortgage Market', *Florida State University Law Review* 33 (2006), 985.

[18] For an interesting and in-depth discussion of vulnerability, mainly from the consumer protection perspective, see Consumer Affairs Victoria, Discussion Paper 'What Do We Mean by "Vulnerable" and "Disadvantaged" Consumers?' (2004).

context of access to low cost credit, vulnerability may have an impact on both lenders and borrowers. However, it is arguable that vulnerability may have more detrimental effects on borrowers, particularly the SMEs. This latter point merits serious consideration.

3.1 Lenders and borrowers: vulnerability for all

Within the context of access to low cost credit, the concept of 'vulnerability' can be viewed from two perspectives. Both the lenders and the borrowers are vulnerable to credit crisis and both have legitimate concerns. Firstly, lenders have vulnerable positions. Since banks borrow from each other (because the interest rate they pay to a bank is cheaper than they pay at deposit markets),[19] during the credit crisis it is argued that they have become vulnerable as a result of restriction on inter-bank loans. Empirical evidence illustrated that, prior to the credit crisis, inter-bank loans were generally made to large banks and 'too-big-to-fail considerations [reduced] the lenders' incentives to control for borrower's risk'.[20] Dinger and von Hagen argue that 'by generating incentives for lending banks to monitor interbank-borrowing banks, interbank exposures may also contribute to prudent market behaviour and reduce the risk of bank failures and systemic distress [as] [t]he idea is that banks are particularly good at identifying the risks of other banks'.[21] Lenders do not wish to extend credit which may be risky. The recent credit crisis triggered lenders' loss of confidence to the market and consumers. Their vulnerability can be explained by the volatility of the economic climate. From another angle, banks have somewhat lost their privileged position. In the UK, the so-called 'rescue culture' has resulted in secured creditors' entitlements being reduced somewhat by recent legislation.[22] This includes, for instance, the floating charge holders'

[19] See V. Dinger and J. von Hagen, 'Does Interbank Borrowing Reduce Bank Risk?', Governance and the Efficiency of Economic Systems Discussion Paper No. 223, November 2007, at 7.

[20] *Ibid.* 13. [21] *Ibid.* 2.

[22] By virtue of the Enterprise Act 2002, Crown preference (listed in Schedule 6 of the Insolvency Act as debts due to Inland Revenue, Security contributions and Customs and Excise) is now abolished by the Act (s. 251) which provides a benefit for floating charge holders, because before the Enterprise Act 2002 preferential debtors in insolvency of the debtor used to be paid in advance of floating charge holders. On the other hand, secured creditors will lose some of their entitlements under s. 252 of the Act which is inserted as s. 176A of the Insolvency Act.