

Neuberger, Doris; Reifner, Udo

Working Paper

Systemic usury and the European Consumer Credit Directive

Thünen-Series of Applied Economic Theory - Working Paper, No. 161

Provided in Cooperation with:

University of Rostock, Institute of Economics

Suggested Citation: Neuberger, Doris; Reifner, Udo (2019) : Systemic usury and the European Consumer Credit Directive, Thünen-Series of Applied Economic Theory - Working Paper, No. 161, Universität Rostock, Institut für Volkswirtschaftslehre, Rostock

This Version is available at:

<http://hdl.handle.net/10419/200245>

Standard-Nutzungsbedingungen:

Die Dokumente auf EconStor dürfen zu eigenen wissenschaftlichen Zwecken und zum Privatgebrauch gespeichert und kopiert werden.

Sie dürfen die Dokumente nicht für öffentliche oder kommerzielle Zwecke vervielfältigen, öffentlich ausstellen, öffentlich zugänglich machen, vertreiben oder anderweitig nutzen.

Sofern die Verfasser die Dokumente unter Open-Content-Lizenzen (insbesondere CC-Lizenzen) zur Verfügung gestellt haben sollten, gelten abweichend von diesen Nutzungsbedingungen die in der dort genannten Lizenz gewährten Nutzungsrechte.

Terms of use:

Documents in EconStor may be saved and copied for your personal and scholarly purposes.

You are not to copy documents for public or commercial purposes, to exhibit the documents publicly, to make them publicly available on the internet, or to distribute or otherwise use the documents in public.

If the documents have been made available under an Open Content Licence (especially Creative Commons Licences), you may exercise further usage rights as specified in the indicated licence.

Thünen-Series of Applied Economic Theory
Thünen-Reihe Angewandter Volkswirtschaftstheorie

Working Paper No. 161

**Systemic Usury and the European Consumer Credit
Directive**

by

Doris Neuberger and Udo Reifner

Universität Rostock

Wirtschafts- und Sozialwissenschaftliche Fakultät
Institut für Volkswirtschaftslehre

2019

Systemic Usury and the European Consumer Credit Directive

Doris Neuberger^{*} and Udo Reifner^{**}

Abstract

Usury is a frequent occurrence in consumer credit markets and particularly affects low-income households. Systemic usury exploits poverty by shifting usury into additional products and leveraging usury gains by stringing together individual loan agreements. This paper reviews the economic rationale for usury legislation and on this basis evaluates the European Consumer Credit Directive 2008/48/EC. Systemic usury is a market failure. The most powerful explanations for such failure in consumer credit markets are monopoly power, where the consumer is locked in a bilateral credit relationship, discrimination through risk-based pricing, and negative externalities, where the least solvent borrowers are cross-subsidized by the more solvent ones. Incomplete information of consumers cannot explain systemic usury in credit markets, because even fully informed consumers would be discriminated and trapped into a situation of bilateral monopoly. However, the European Consumer Credit Directive is primarily based on the model of incomplete information, which it seeks to correct by informational duties. As a consequence, usurious practices and products are implicitly acknowledged as legal, which has eroded the national combat against usury. Therefore, this Directive is not effective and must be reformed.

JEL classification: D14, D18, D42, D62, D63, G21, G28, K15, K22, K33, L12, L14

Keywords: discrimination, Consumer Credit Directive, incomplete information, payment protection insurance, overindebtedness, monopoly power, responsible lending, risk-based pricing, usury

July 12, 2019

*University of Rostock, DIW Berlin, CERBE Rome, e-mail: doris.neuberger@uni-rostock.de

** University of Hamburg, e-mail: udo.reifner@uni-hamburg.de

1. Introduction

In modern capitalist economies, the term usury refers to inflated prices in the form of money or rent or too low prices in the form of low wages. The fact that political extremism morally condemns usury is no longer justified. It has its cause in a historical outdated critique of capitalism. The agricultural economy had to regard interest on labour-free capital as exploitation in principle (Hecker, 2019). Today, loan usury is no worse or better than rent and wage usury.

Transactions with usurious content are declared null and void in German civil law in §138 BGB. §291 of the Criminal Code makes usury a punishable offence and particularly emphasises usury in credit and housing, but also includes usury in wages (BAG v. 22.04.2009 - 5 AZR 436/08).

Usury is the abusing or exploiting of an economically weak situation for the content of contracts whose services are conspicuously one-sidedly burdensome. While with *individual usury* (§138 Abs.2 BGB) the usurer consciously and purposefully exploits the misfortune or defencelessness of another, with *systemic usury* (= social usury §138 Abs.1 BGB) in the form of social discrimination the permanently socially weak position of poor clients manifests itself in a seemingly personal attribute of an elevated risk usury is derived from. In the first case the legal as well as moral unworth judgement lies on the malice of the acting lender (deception, fraud, overreaching, greed), in the second case it is the effect of usury on the borrower (over-indebtedness, impoverishment) which the law tries to prevent.

The law therefore speaks of a threshold, the conspicuous imbalance between the agreed wage or price and a usual or normal remuneration. In labour law, this benchmark is derived from the standard wage, in credit law from the average interest rates charged by the ECB and, in tenancy law, from the average rents for comparable dwellings as shown in the rent indexes of local authorities. While the courts set the limit for rent and wages at two thirds above average and one third below average respectively, in German credit law (France and Italy also remain at two thirds) only twice the usual is considered conspicuous. Ultimately, the decisive factor is whether the wage or price deviates so conspicuously from the usual that one has to assume that a market failure has been systematically abused.

The fact that systemic usury is of such importance for work, housing and credit is mainly due to the fact that, on the one hand, the goods acquired such as jobs, housing and access to future income (credit) are indispensable and have an existential significance. They are also more difficult for the low-income classes to reach. Furthermore, these groups are relatively strongly and without alternative involved in it, so that they find it difficult to break away from the circumstances and decide in favour of other offers. With employers, landowners and banks, they are also faced with relatively powerful contractual partners who forego the offer, behave like cartels with regard to low-income households and can develop a high degree of collective power.

These weaknesses have been recognised by the law with the specificity of worker, tenant and consumer protection. It covers however often only the market position and has interested itself so far for the civil-legal usury toward unemployed ones, housing seekers and overindebted only little. Subsidies under social law such as housing subsidies, Hartz IV and

social credits are intended to alleviate the excesses. That increased however the possibilities of the usury rather than decreased it. 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 application to consumer credit markets. On this basis, Section 3 summarizes an evaluation of the European Consumer Credit Directive 2008/48/EC (CCD 2008) with regard to the spread of usurious credit in Europe, which has been mandated by the German Coalition against Usury¹ in connection with the European Coalition for Responsible Credit (ECRC) (Reifner et al. 2019; see also Reifner 2018). Section 4 concludes.

2. Systemic usury as market failure in consumer credit markets

In a market economy, the prohibition of usury must be justified by market failure. With the exception of Adam Smith, most classical economists believe that usury laws are "...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) argues that usury cannot exist as long as the transaction is voluntary. Usury limits would prevent mutually agreed trades and reduce welfare by reducing the supply of credit. This libertarian view is shared by neoclassical economists still today (e.g. Labat and Block 2012, Baker and Breitenstein 2010). In modern mainstream economics textbooks the word usury is usually missing. Labat and Block (2012) apply this libertarian logic to any credit market, including the market of payday lending, "which Bentham never contemplated when he set out to defend usury" (Mayer 2013, p.516). Mutually agreed trades must be beneficial to both parties and therefore cannot be exploitative or unfair (Labat and Block 2012, p.385). However, exploitation or wrongful gain can occur also in voluntary, fully informed and mutually advantageous trade, which has been admitted even by libertarian thinkers (Mayer 2013, p.515).

Market failure in consumer credit markets may result from (1) monopoly power, (2) discrimination through risk-based pricing, (3) negative externalities and (4) incomplete information of consumers.

2.1. Monopoly power

Monopoly power results from unequal bargaining power. In the case of systemic credit, rental and wage usury, the systemic aspect lies in the inescapability. The socially weak do not pay more or receive less because they demand or offer a more cost-intensive service. Even if he works just as well as others, rent and installments are always paid on time, he should only be able to choose within an offer where he spends considerably more or earns

¹ 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).

correspondingly less than the average. He belongs to a group from which he cannot escape statistically. Therefore, "The Poor Pay More" (Caplovitz 1963).

In the case of over-indebted borrowers at the brink of insolvency, we even have a situation of bilateral monopoly. If a consumer can no longer service a credit or urgently needs additional credit, he must turn to his previous lender. Therefore, the customer is bound to the bank (lock-in), giving rise to a hold-up problem. Conversely, the bank is bound to the customer by the credit default risk and is interested in extending the customer relationship by selling new products.²

In this case, the price can theoretically not be determined exactly, but only limited. The upper limit is given by the monopoly price if the bank is regarded as the sole supplier (monopolist) and the customer as the quantity adjuster. The lower limit results as a monopsony price from the reversed power constellation, if the customer is regarded as the only buyer (monopsonist) and the bank 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 bank, all three factors are pronounced to the detriment of the customer, so that the monopoly price or a usurious offer is created: (1) The bank has greater negotiating skills, as it can credibly give the customer the impression that it will break off negotiations if he fails to fulfil a certain claim. Termination of the relationship would result in insolvency or high costs for the consumer, who does not have an alternative. (2) A consumer on the threshold of over-indebtedness, unlike a bank, has too little financial reserve to wait for the conclusion of a new transaction or to renounce it altogether. (3) Lack of information on the actual situation of the bank may weaken the relative power of consumers. For example, households are unlikely to threaten to break off their banking relationship because they are unaware that this would harm the bank.

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. (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).

² 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).

The 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 a credit relationship described above, however, it can be assumed that the bank has such a strong power position over a low-income household that the bank acts as the option fixer and the customer as the option recipient. Systemic usury on credit markets can thus be interpreted as a bilateral monopoly between a bank and a threshold household, whereby the bank fixes the price-quantity offers and thus abuses its monopoly power. Empirical evidence shows that the demand for payday loans is relatively price inelastic, so that competition does not work (Avery and Samolyk 2011, pp. 4,19, Mayer 2013, p. 518).

While the individual loan often looks good, usury is based on the sequencing of individual credit agreements and additional products such as payment protection insurance. In the face of a hopeless over-indebtedness, the bank makes the consumer an offer to reschedule the debt, which he practically cannot refuse at usurious conditions. The bank can offer a new interest rate, new products, instalments etc. with each rescheduling. The consumer will accept everything because there is no alternative. Bentham's condition of voluntary transactions for mutual benefit is therefore not fulfilled.

Banks often force consumers to take out insurance policies to ensure the repayment of his credit. These insurances are comparatively expensive and are tailored to the needs of the bank. According to a survey of the German Financial Authority BaFin, payment protection insurance (PPI) mostly represents at least 50% of the non-disclosed cost of credit. In individual cases customers with a lower credit rating receive a loan only if they take out a PPI policy (BaFin 2017). An investigation of installment credits shows that for almost one third of the contract offers, the effective interest rate was at least 100 percent above the market interest rate with insurance included in the calculation. In some cases, the effective interest rate was even more than 20 percent. In many cases, PPIs are taken out by means of considerable pressure to sell, in part as a mandatory prerequisite for the granting of credit (Ulbricht et al. 2019).

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 them, so that risk-based pricing relies solely on observable risk factors for groups of borrowers, classified e.g. according to income or assets³. This assumes that the mere fact that someone has a low income makes him 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,

³ So-called third-degree price discrimination or group-pricing, which increases a monopolist's profits (Belleflame and Peitz 2015, pp.198)

ASB Schuldenberatungen 2014, Civic Consulting 2013). In a well-functioning capital 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. On the other hand, social discrimination through risk-based pricing reduces welfare by narrowing down macroeconomic risk-sharing (Reifner 2017a, pp. 75).

This market failure involves a self-fulfilling prophecy: With the increased risk premium due to risk-based pricing, liquidity decreases so that the risk becomes inescapable as a result of usurious interest rates. This is supported by empirical literature (e.g. Ards et al. 2015 for US consumer loans). In the US business loan market, minority business owners have higher rates of 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 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 of their behavior (Kau et al. 2012).

2.3. Negative externalities

Another justification for usury ceilings are negative externalities. Credit markets may fail because (even mutually beneficial) transactions affect third parties who bear costs without benefitting from the exchange. Free credit markets may produce two kinds of externalities. First, excessive risk-taking (moral hazard) may harm the public at large and taxpayers in particular, who are likely to bear the costs by higher taxes (Posner 1985). However, evidence about whether this applies to consumer credit markets such as payday lending is inconsistent (Caskey 2010, Melzer 2011, Morse 2011, Mayer 2013, p.525).

The second kind of negative externalities seems to be more certain in such markets: deregulated pricing in payday lending involves cross-subsidization of the least solvent borrowers by the more solvent ones. When the creditors lend to the riskiest debtors with high interest rates in the absence of usury ceilings, the more solvent majority of borrowers will be taxed to cover the greater losses. They subsidize 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.

Empirical literature shows that higher interest rates 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. “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. Incomplete information of consumers

Lack of information is another source of market failure. According to the information market model of the 'responsible' or literate consumer, more effective information disclosure might be able to correct this, obviating the need for the imposition of usury ceilings (Bertrand and Morse 2011, Mayer 2013, p.523). However, incomplete information is a weak explanation for systemic usury in consumer credit markets, because even fully informed consumers would be trapped into 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.

3. Evaluation of Directive 2008/48/EC with regard to the spread of usurious credit in Europe

3.1. CCD and usury

The CCD 2008 has had problematic effects on the national combat against usury. It has eroded its foundations through a methodology of legislation in which usurious practices and products are implicitly acknowledged as legal because the Directive only links informational duties to their existence.

The problem comes principally from the fact that:

- there are more than four different and inconsistent definitions of interest rates;
- the use of the word 'interest', which is a core concept in national usury legislation, is used arbitrarily in the Directive giving suppliers far too much discretion to adapt its definition(s) to suit their needs, leading to major restrictions being circumvented.

Because of the multitude of contradicting definitions the Directive has not achieved the promised results regarding transparency and information. Consumers need to be given information on an APRC (annual percentage rate of charge) which represents all the payments they are required to make to obtain the credit. In practice, the omission of insurance premiums from the costs that need to be included has led to APRC that reflect less than 50% of the cost of credit. Besides, the provision of a consistent payment plan based on the APRC is denied to consumers. Instead of a payment plan Art. 10 (2) (i) only requires an arbitrarily calculated amortisation table which has only to be handed out after conclusion of the contract.

The Directive thus implicitly contributes to social discrimination by accepting that “the poor pay more”. This tendency is linked to a 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. Art. 16 of the Directive governing early repayment is used in a way which exploits the borrowers.

The initial draft of the Directive took care to require good standards of behaviour from lenders, by imposing a principle of responsible lending. However, the Directive itself as it was adopted instead requires that the consumer borrows responsibly. The principle of responsible borrowing protects usurious products and practices blaming consumers (and in particular the vulnerable) for the consequences of choosing a usurious product.

The solutions of the CCD assume that only markets with transparent information can cure the problems of exploitation and overindebtedness. This ideology has led to an information overload, where hundreds of pages of fine print with ever repeated inconsistent information hinder the search for valuable information even for specialists. Usury assessment by credit advisors and courts has become nearly impossible. The right of withdrawal is not an adequate alternative. Although not yet surveyed by the Commission it is probably not at all used in the EU for purposes it has been introduced.

3.2. 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.’

However, the effects of the Directive have not been to create an internal market where consumers enjoy a high level of protection with regards to usury practices, quite the contrary. It is full harmonisation that is at the root of the problem spreading across Europe and causing the most vulnerable to be harmed by usury credit practices.

The yardstick for the CCD 2008 should have been the lessons learned from the financial crisis 2008 expressed especially by the ten G20 high level principles on Financial Consumer Protection (OECD 2011)⁴ and the seven ECRC Principles of Responsible Credit (ECRC 2014).⁵ There is much reason to believe that the “subprime” (= usury) 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).

Usurious credit and overindebtedness were the core concern of the first draft for the Directive back in 2002. The draft had been thoroughly prepared using empirical research mandated by DG Consumer Protection and Health. However, the essence of this draft

⁴ 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).

⁵ 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).

Directive was lost and the 2008 final version of the Directive instead follows the opposite path paving the way for the development of a usurious consumer credit market exploiting the poorest in our societies because the Directive chose information as a means to control credit practices.

The final version of the Directive omitted consumer protection, prevention of overindebtedness and usury from its goals by contrast with the original draft. They were replaced with “harmonisation” (Art. 1) that seemingly justified the “imperative nature of this Directive” (Art.22). This was in spite of surveys mandated by the Commission that showed that there neither lenders nor consumers expressed a need for consumer credit to be bought or sold across the border in another Member State (Reifner et al. 2006). The only responses indicating such need were small banks located in Luxembourg or Switzerland. It is our view that those institutions are trying to escape effective bank supervision and practicing usurious terms of lending. Recital 9 of the Directive does mention that substantive consumer and debtor protection remains unaffected. However, the fact that definitions are open to one-sided manipulations frees those who have the power to do so from traditional legal restrictions.⁶

The Directive has a major flaw with regard to usury: it claims that it does not affect existing national protective legislation and at the same time in the name of providing transparency evokes a number of usurious products for whom general civil law would be competent. Choice is supposed to replace rights. Exploitation, usurious practices and the systemic misuse of bank 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 prevents sanctioning usury because its rules are not applicable if a consumer is deemed to have chosen (“not compulsory” Art. 3 (g)) a transparent product. Thus, usurious refinancing, PPI, wrong interest rate calculations, anatocism, compulsory refinancing, chain contracts, flipping and churning as well as credit where repayments are deviated into investment products with negative return are indirectly justified so long as the consumer was given the required information.

With its total harmonisation approach the Directive discriminates especially against poor people and breaks the commitment to a high level of consumer protection. 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) which 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 CCD 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.

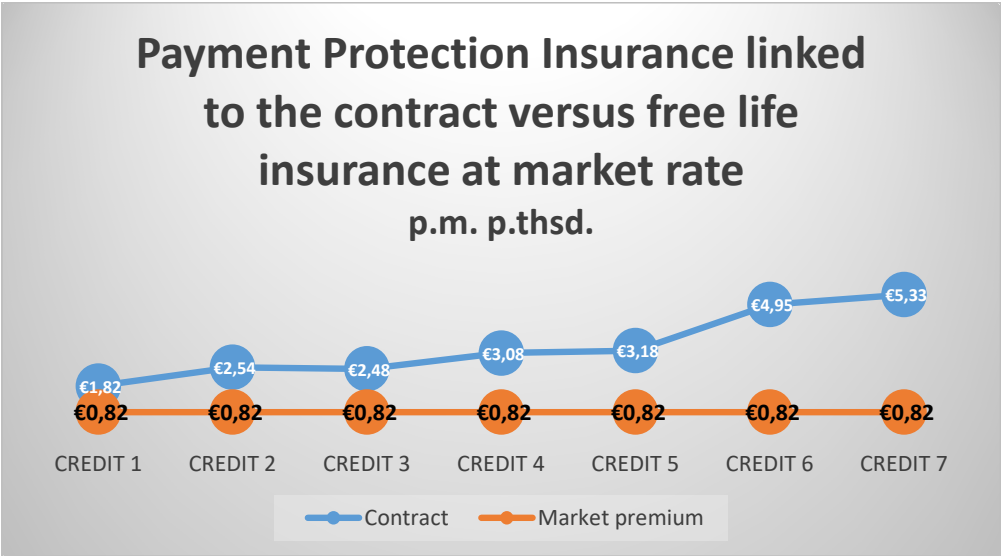
3.3. Usurious credit in practice

⁶ For an overview see Reifner and Schroeder (2012).

Instead of listing the numerous constructions in which banks are allowed to make usurious loans, we represent a typical credit chain of a large international consumer credit bank, where the original contract in 09/2003 was refinanced six times until 10/2012. Each of the following contracts was linked to a new financed PPI, which steadily increased to nearly five times its initial cost and much more in terms of life insurance at market premium that is not linked to a loan (see Figures 1 and 2). At each refinancing, the bank cancelled the ongoing insurance contract and concluded a new one, with ever growing usurious premiums for basically the same risk.

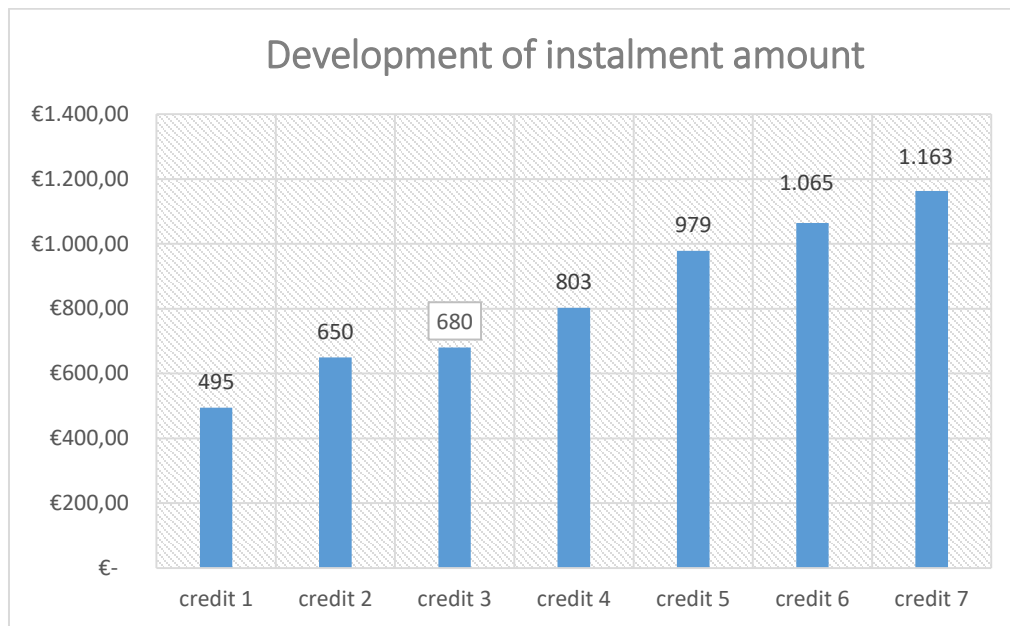
The APRC required by the Directive was indicated in the contracts between 15.76% p.a. and 11.24% p.a.. The mathematical definition in the annex requires that all instalments paid by the consumer are in proportion to all payments made by the bank to him or her. If this had been done neglecting the artificial separation into seven contracts, the correct APRC for the whole relationship would have been 25.12 % p.a. The calculation allowed by the Directive therefore significantly underestimates the usurious burden that this borrower has to bear. While the EU Commission commissioned empirical and mathematical research in 1998 to correctly understand the problems (Reifner et al, 1998) in the preparation of its 2002 draft, CCD 2008 did nothing similar, although in particular the UK authorities supported by the press⁷ have shown the true dimensions undisclosed PPI has for usurious loans.

Figure 1: Cost of Payment Protection Insurance



⁷ 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), <https://www.theguardian.com/business/2016/aug/02/ppi-claims-all-you-need-to-know-about-the-mis-selling-scandal> (27.05.2019)

Figure 2: Instalment payments in the credit chain



3.4. What consumers would need

Consumer credit provides access to future income for consumers who do not have sufficient liquidity and savings to pay in advance for the purchase of durables (cars, household appliances, computers, etc.), to bridge temporary liquidity crises (birth of children, illness, unemployment, education, etc.) or to invest in the future of young families (appliances, homes, education, job, etc.). For this they have to choose 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) with the above market failures.

The APRC plays a decisive role for all three functions. The Annex to the Directive refers to the only mathematical and therefore correct parameter to represent prices (truth in lending), to distribute costs evenly over the duration and amount of the outstanding loan (accessory principle) and to identify where an interest rate is “grossly disproportionate” to average market prices (usury).

From a technical point of view, 20 pages of repeated and superfluous descriptions of mostly identical information about rarely occurring marginal facts and situations do not provide the necessary basis for a rational decision.

Instead, a consumer credit agreement should culminate in the information compiled through a comprehensive payment plan. It would show what and when a consumer gets money at what time and what he has to pay to the bank. 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 he or she has received the promised amount at the due date. This would allow to compare the most important parameters and

avoid information overflow. Such a regime is in use in the US. 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 loan interest rate is used to calculate the residual debt in case of early repayment.

4. Conclusions

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). The present paper reviews the economic rationale for usury legislation and on this basis summarizes the paper of Reifner et al. (2019) which has been submitted to the Open Public Consultation on the Evaluation of Directive 2008/48/EC. This paper demonstrates that there is an urgent need for the Directive to address this problem.

The CCD needs a new beginning in which the 2002 Draft of the EU-Commission which proposed a consistent regulation to combat usury and prevent overindebtedness could play an important role. The first step should be the abolition of the imperative character of this Directive with regard to national law. This could allow the development of a more consistent, transparent and focused consumer credit law as it was in force in many countries before the CCD intervened.

Art. 3 g)⁸ of Directive 2008/48 states that the total cost of the credit to the consumer means ‘all the costs, including interest, commissions, taxes and any other kind of fees (...)’. Costs for ancillary services relating to the credit agreement, in particular insurance premiums, are also included if, in addition, “the conclusion of a service contract is **compulsory** in order to obtain the credit or to obtain it on the terms and conditions marketed”. This part of the definition of the notion of total cost of credit should be changed back to the wording of Art. 12 (2) of the initial proposal COM(2002) 443 final of 11.9.2002 where the last limb of the sentence read: “if the insurance is taken out **when** the credit agreement is **concluded**.”

This simple return to the original requirement would revitalize national usury law whose application could stop the misuse of Payment Protection Insurance for usurious credit. The imperative nature of the Directive has influenced significantly national civil law in all Member States and has led to the perverse situation whereby usurious payment protection insurance is now in all European contracts defined as “non-compulsory” although it represents up to 50% of the non-disclosed cost of credit and is often taken out by means of considerable pressure to sell, and especially in the case of vulnerable consumers as a mandatory prerequisite for the granting of credit (Ulbricht et al. 2019, BaFin 2017). It is lenders who benefit from this.

⁸ Reiterated in Art. 4 (3); 5 k); Annex II No 3 (3)

References

- Ards, S.D., Ha, I.S., Mazas, J.L. (2015), Bad Credit and Intergroup Differences in Loan Denial Rates, *The Review of Black Political Economy*, 42, 19-34.
- ASB Schuldnerberatungen (2014), Over-indebtedness Report Austria 2014, Linz, https://www.schuldenberatung.at/downloads/english/Overindebtednessreport2014_EndV.pdf
- Avery, R.B. and Samolyk, K. A. (2011), Payday Loans versus Pawn Shops: The Effects of Loan Fee Limits on Household Use (September 9, 2011), <http://dx.doi.org/10.2139/ssrn.2634584>
- BaFin (2017), Ergebnisbericht zur Marktuntersuchung Restschuldversicherungen, Bundesanstalt für Finanzdienstleistungsaufsicht, Berlin, 21.06.2017.
- Baker, D., Breitenstein, M. (2010), History repeats itself: Why interest rate caps pave the way for the return of the loan sharks, *Banking Law Journal*, 127, 581–603.
- Banque de France (2014), Study of Paths Leading to Over-Indebtedness, Directorate General, Cash Management and Branch Network Activities Consumer Affairs, Research and Projects Department, Paris.
- Bayer, P., Ferreira, F., Ross, S.L. (2018), What Drives Racial and Ethnic Differences in High-Cost Mortgages? The Role of High-Risk Lenders, *The Review of Financial Studies*, 31(1), 175-205.
- Becker, G.S. (1957), *The Economics of Discrimination*, University of Chicago Press, Chicago, IL.
- Belleflamme, P., Peitz, M. (2015), *Industrial Organization - Markets and Strategies*, 2nd edition, Cambridge University Press, Cambridge.
- Bentham, J. (1787), *Defence of usury; shewing the impolicy of the present legal restraints on the terms of pecuniary bargains*. London: T. Payne and Son.
- Bertrand, M., Morse, A. (2011), Information disclosure, cognitive biases, and payday borrowing, *Journal of Finance*, 66, 1865–1893.
- Boot, A.W.A. (2000), Relationship Banking: What Do We Know? *Journal of Financial Intermediation*, 9, 7–25.
- Caplovitz, D. (1963), *The poor pay more: Consumer practices of low- income families*, New York: Free Press.
- Caskey, J. (2010), Payday lending: New research and the big question, Working paper, Federal Reserve Bank of Philadelphia.
- CCD (2008), Directive 2008/48/EC of the European Parliament and of the Council of 23 April 2008 on credit agreements for consumers and repealing Council Directive 87/102/EEC, *Official Journal of the European Union*, L 133/66, 22.5.2008.

Civic Consulting (2013), The over-indebtedness of European households: updated mapping of the situation, nature and causes, effects and initiatives for alleviating its impact – Part 1: Synthesis of findings, Berlin.

Coco, G., de Meza, D. (2009), In defense of usury laws, *Journal of Money, Credit and Banking*, 41, 1691–1703.

ECRC (2014), Principles of Responsible Credit, <https://www.responsible-credit.net/index.php?id=2516> (27.05.2019)

Hecker, C. (2019), „Ex contingente necessarium ...“ (M. Luther) – Der ökonomische Kern moralphilosophischer Zinskritik, *Vierteljahrshefte zur Wirtschaftsforschung/Quarterly Journal of Economic Research*, forthcoming.

Kau, J.B., Keenan, D.C., Munneke, H.J. (2012), Racial Discrimination and Mortgage Lending, *Journal of Real Estate Financial Economics*, 45, 289–304.

Labat, A., Block, W. (2012), Money does not grow on trees: An argument for usury, *Journal of Business Ethics*, 106, 383–387.

Li, M., Mumford, K., Tobias, J. (2012), A Bayesian analysis of payday loans and their regulation, *Journal of Econometrics*, 171(2), 205-216.

Lindley, J.T., Selby, Jr., E.B., Jackson, J.D. (1984), Racial Discrimination in the Provision of Financial Services, *The American Economic Review*, 74 (4), 735-741.

Mayer, R. (2013), When and Why Usury Should be Prohibited, *Journal of Business Ethics*, 116, 513–527.

Melzer, B. (2011), The real costs of credit access: Evidence from the payday lending market, *Quarterly Journal of Economics*, 126, 517–555.

Mill, J. S. (1891), *Principles of Political Economy*, London: Longmans, Greens and Co. People's Edition.

Morse, A. (2011), Payday lenders: Heroes or villains? *Journal of Financial Economics*, 102, 28–44.

OECD (2011), G20 High-level Principles on Financial Consumer Protection, Organisation for Economic Co-operation and Development, Paris, October 2011.

Posner, E. (1995), Contract law in the welfare state: A defense of the unconscionability doctrine, usury laws, and related limitations on the freedom to contract, *Journal of Legal Studies*, 24, 283–319.

Reifner, U. (2017a), *Das Geld Band 2: Soziologie des Geldes – Heuristik und Mythos*, Springer, Wiesbaden.

Reifner, U. (2017b), *Die Finanzkrise - Für ein Wucher- und Glücksspielverbot*, Springer, Wiesbaden.

Reifner, U. (2018), Responsible Credit in European Law. *The Italian Law Journal*, 4(2), 421-448.

Reifner, U., Gibbons, D., Neuberger, D., Riefa, C. (2019), Evaluation of Directive 2008/48/EU with regard to the spread of Usurious Credit in Europe, Paper mandated by the German Coalition against Usury in connection with the European Coalition for Responsible Credit (ECRC), Hamburg.

Reifner, U., Pérez-Carillo, E., Knops, K.O, Tiffe, A., Clerc-Renaud, S. (2006), Analysis of the Economic Impact of Directive 2002/65/EC concerning the distance marketing of consumer financial services on the conclusion of cross-border contracts for financial services between suppliers and consumers within the Internal Market Final Report, Institut für Finanzdienstleistungen to DG Sanco, Project No. SANCO/2006/B4/034.

Reifner, U., Schroeder, M. (2012), Usury Laws - A legal and economic Evaluation of Interest Rate Restrictions in the European Union, BoD: Norderstedt.

Reifner, U., Wüst, M., Haida, L., Bonhomme, C. (1998), Harmonisation of Cost Elements of the Annual Percentage Rate of Charge, APR, Project No.: AO-2600/97/000169, Hamburg, <http://www.responsible-credit.net/media.php?t=media&f=file&id=2221>

Robb, A., Robinson, D.T. (2018), Testing for racial bias in business credit scores, Small Business Economics, 50, 429-443.

Schumann, J., Meyer, U., Ströbele, W. (2011), Grundzüge der mikroökonomischen Theorie, Berlin, Heidelberg: Springer.

Ulbricht, D., Peters, S. (2018), iff-Überschuldungsreport 2018. Überschuldung in Deutschland, institut für finanzdienstleistungen, Hamburg.

Ulbricht, D., Feigl, M., Freistedt, U., Peters, S., Schacht, G. (2019), Faire Kreditvergabe, iff Hamburg.