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Comparato, Guido (2019) Debt and relief: a holistic approach to the legal treatment of consumer debt. *European Review of Contract Law* 15 (1), pp. 1-30. ISSN 1614-9920.

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## Debt and Relief

### A holistic approach to the legal treatment of consumer debt

**Guido Comparato**<sup>1</sup>

*Abstract: The awareness that consumer over-indebtedness is a problem which needs to be tackled through specific measures most clearly emerged at the end of a period in which increased availability of retail financial services was presented as a means to promote consumers' welfare. While, on the one hand, over-indebtedness is regarded as a problem to be counteracted, European law and policy, on the other hand, promote indebtedness, leading to a fragile equilibrium between opposing purposes which permeate the regulatory framework. How can the two objectives be reconciled, allowing for well-ordered development of a credit-based economy in which debtors in financial trouble are not left behind? This paper suggests the necessity of taking a holistic approach to over-indebtedness, starting from the assumption that, rather than being the manifestation of individual inability to properly deal with finance, the phenomenon is inherent to a credit economy and that modern law must therefore tackle it systematically through a combination of measures: private and public, contractual and non-contractual, preventive and curative, national and supranational. While articulating a critique of some of the rationales underlying 'debt law', the paper highlights the necessary interrelation between the possible legal strategies against household over-indebtedness and the need to coordinate them in order to reach an adequate level of protection.*

*Zusammenfassung: Die Wahrnehmung, dass Verbraucherüberschuldung ein nach spezifischen Gegenmaßnahmen verlangendes Problem ist, tauchte deutlich am Ende einer Periode auf, in der der erleichterte Zugang zu Finanzdiensten als ein Instrument der Verbraucherwohlfahrt präsentiert wurde. Auf der einen Seite wird Überschuldung jetzt als ein zu bekämpfendes Problem betrachtet; auf der anderen Seite hat die Europarechtspolitik der letzten Jahre Verschuldung sogar befördert. Das führt zu einem instabilen Gleichgewicht zwischen sich womöglich widersprechenden gesetzlichen Zielen. Wie kann man diese zwei Ziele miteinander versöhnen und die Entwicklung einer Kreditökonomie ermöglichen, ohne dass Schuldner in Schwierigkeiten vergessen werden? Dieser Artikel suggeriert die Notwendigkeit eines holistischen Ansatzes zur Überschuldung, der davon ausgeht, dass das Phänomen in der Regel nicht das Resultat von individueller Unfähigkeit mit Geld umzugehen ist, sondern der Kreditökonomie inhärent ist. Es sollte deshalb systematisch durch eine Kombination von rechtlichen Maßnahmen bekämpft werden: privat und öffentlich, vertraglich und außervertraglich, präventiv und kurativ, national und supranational. Indem er einige der dem Recht der Schulden zugrundeliegenden Gedankengänge kritisiert, hebt der Artikel die Wechselwirkung zwischen möglichen Strategien gegen Haushaltüberschuldung hervor und betont die Notwendigkeit, sie zu koordinieren, um ein angemessenes Schutzniveau zu erreichen.*

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The author would like to thank the anonymous reviewers for their useful comments.

*Resumé : La prise de conscience du fait que le surendettement du consommateur est un problème à affronter avec des mesures spécifiques s'est accrue à la fin d'une période où un accès plus aisé aux services financiers était vu comme un instrument pouvant accroître le bien-être du consommateur. Tandis que le surendettement est considéré comme un problème qu'il faut combattre, la politique du droit européen promeut l'endettement. Dans le cadre réglementaire, cela aboutit à un équilibre instable entre deux objectifs contradictoires. Comment peut-on réconcilier les deux, en rendant ainsi possible le développement d'une économie du crédit où les débiteurs en difficulté ne sont pas abandonnés ? Cet article suggère qu'il est nécessaire de choisir une approche holistique face au surendettement, basée sur le présupposé que, loin d'être la manifestation d'une incapacité individuelle de bien gérer son argent, le phénomène est inhérent à l'économie du crédit. Par conséquent, le droit doit y faire face systématiquement par la combinaison de mesures différentes : privées et publiques, contractuelles et non-contractuelles, préventives et curatives, nationales et supranationales. Tout en présentant une critique de la logique qu'inspire le droit de la dette, cet article souligne les corrélations entre les possibles stratégies juridiques vis-à-vis du surendettement et la nécessité de les coordonner, afin d'atteindre un niveau adéquat de protection.*

## **Introduction**

The twentieth and twenty-first century policies of the 'democratisation of finance'<sup>2</sup> and of 'financial inclusion'<sup>3</sup> encouraged a growing number of consumers to obtain credit and financial products on more accessible conditions,<sup>4</sup> leading to more individuals incurring excessive debt and over-indebtedness. Yet, awareness of the problem of citizens' over-indebtedness is not new. Instead, this has regularly emerged at various historical junctures,<sup>5</sup> with corresponding calls for public intervention. Notably in ancient Greek law, as well as Roman law, we find moratoria meant to set debtors free from their obligations,<sup>6</sup> often motivated by public policy considerations relating not so much to macroeconomic risks - as the problem is often phrased nowadays - but rather in public order concerns, as the level of indebtedness put societal peace at risk. The concept of 'Jubilee', in its original biblical meaning of cyclical remission of sins and debts, is innately tied to the history or at least the mythology of debt. Those interventions of public relief compensated for the strictness of legal rules which did not easily allow for relief, as they safeguarded the interest of the creditor instead and resulted in severe

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<sup>2</sup> I. Erturk, J. Froud, S. Johal, A. Leaver, and K. Williams, 'The democratization of finance? Promises, outcomes and conditions' (2007) 14 *Review of International Political Economy* 553-575

<sup>3</sup> S. Collard, 'Toward Financial Inclusion in the UK: Progress and Challenges' (2007) *Public Money & Management*, 13-20

<sup>4</sup> On access to financial services, H.-W. Micklitz, 'Access to, and Exclusion of, European Consumers from Financial Markets after the Global Financial Crisis' in T Wilson, *International Responses to Issues of Credit and Over-indebtedness in the Wake of Crisis* (Farnham, Ashgate) 47-78.

<sup>5</sup> In an anthropological perspective, D. Graeber, *Debt. The first 5000 years* (Penguin Books, 2012)

<sup>6</sup> A.D. Manfredini, *Rimetti a noi i nostri debiti. Forme della remissione del debito dall'antichità all'esperienza europea contemporanea* (Bologna: il Mulino, 2013)

sanctions for the insolvent debtor with a view to uphold public confidence.<sup>7</sup> Against that background, the strict formalism of private law could be maintained over the centuries only by permitting public interventions to act as a relief valve whenever the pressure caused by indebtedness became socially unsustainable: celebrated principles nowadays expressed in terms of *Geld muss man haben* and *pacta sunt servanda*, which suggest the image of an uncompromising law, could thus dominate over contract law only inasmuch as public powers occasionally intervened *ex machina* to remedy the social problems codetermined by those very principles. While the regulation of commerce later allowed for mechanisms to orderly deal with commercial debt - yet characterised by a strong punitive approach ranging from imprisonment to loss of political rights of the debtor in continuity with the archaic attitude - the civil debtor remained exposed to the harshness of general principles even when the evolution of a consumer society magnified the problem of debt. The historical perspective reminds us, therefore, of the importance of looking at the legal treatment of debt in a comprehensive way, considering how different doctrines and measures interact, delineating the broader law and policy of debt.

What is then the contemporary policy approach towards private debt? The approach of private law, in particular European private law, to the issue appears to be marked by a twofold and possibly contradictory attitude. On the one hand, over-indebtedness is now widely recognised as a problem to be counteracted;<sup>8</sup> on the other hand, major economic and legal developments encourage the extension of debt for both economic and social goals, consistent with the ‘democratisation of finance’ policy.<sup>9</sup> This twofold approach results in a particularly fragile equilibrium between the different goals which permeate the regulatory framework.<sup>10</sup> While one would expect that private law, and typically contract law, can offer some solutions to over-indebtedness, inasmuch as it regulates the contractual source of debt, there remain serious doubts whether private law is an efficient instrument to that purpose: that branch of the law is mostly based on the idea of self-responsibility and of the private dimension of debt. But is this system sustainable, all the more considering what has been said in terms of the interplay between strict private law rules and public measures occasionally offering debt relief?

Against this framework and rooted in the notion that over-indebtedness is in fact inherent to a credit economy rather than deriving from necessarily isolated and morally repugnant individual behaviours, this contribution suggests the necessity of taking a more holistic approach to

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<sup>7</sup> On the relation between credit and social trust, see C. Muldrew, *The Economy of Obligation. The Culture of Credit and Social Relations in Early Modern England* (London, Palgrave Macmillan, 1998)

<sup>8</sup> F. Ferretti and C. Livada, ‘The over-indebtedness of European consumers under EU policy and law’, in F. Ferretti (ed), *Comparative perspectives of Consumer Over-indebtedness – A view from the UK, Germany, Greece, and Italy* (Eleven Publishing, 2016) 11-37; F. Ferretti, (2015) ‘The over-indebtedness of European consumers: time for a ‘fresh-start’ of the EU policy and legal agenda?’ (2015) 11(4) *European Review of Contract Law* 1-30

<sup>9</sup> G. Comparato, ‘The rationales of financial inclusion in the changing European private law’ (2015) 11(1) *European Review of Contract Law* 22-45

<sup>10</sup> See G. Comparato, *The Financialisation of the Citizen. Social and Financial Inclusion through European Private Law* (Oxford, Hart Publishing, 2018)

the problem. The paper offers a classification of the different strategies that may be deployed and highlights that an optimal approach must rely on a combination of measures, private and public, contractual and non-contractual, preventive and curative, national and supranational - intended as complementary rather than alternative to each other. While articulating a critique of some of the rationales underlying debt law, the paper emphasises the necessary interrelation between the different legal measures and the need to coordinate them in order to reach an adequate level of debtor protection. A multifaceted phenomenon requires a multifaceted response. The paper is structured as follows: the first section will introduce the phenomenon of household over-indebtedness and offer a classification of possible responses to it. The second part will focus on some of those responses, considering in particular those applicable to cases of over-indebtedness rooted in financial contracts, and highlighting their fundamental traits and potential. In the third part, the paper will look more closely at the interrelations between the previously introduced instruments. The conclusion summarises the main points of the contribution further rationalising the relation between instruments aimed at combatting household over-indebtedness. The approach of the paper is European in its broader sense, as it is mostly concerned with European law<sup>11</sup> describing trends in Europe as a whole and drawing from sources of both supranational and national law; needless to say, including the United Kingdom.

## **Different approaches to debt and relief**

In the absence of a single, general legal definition of over-indebtedness, the phenomenon can be taken to mean the non-temporary condition of a debtor having greater debts than he can likely repay. This is further qualified as consumer, or household, over-indebtedness to refer to the amount of debt mainly contracted by a civil debtor and his or her family for reasons mainly falling outside the scope of his or her commercial or professional activity. The specific features and manifestations of over-indebtedness might then differ according to various contexts and countries.<sup>12</sup> Rather than defining or describing that phenomenon in general terms, it seems more important for our purposes to draw an initial distinction between sources and causes of over-indebtedness. Contracts can be said to be one of the ‘sources’ of indebtedness. Indebtedness as such is a rather generic term which conceives a plurality of debts stemming from a multitude of contracts and social interactions. Seen this way, indebtedness is a normal economic occurrence: a well-functioning economy simply could not operate without exchanges between individuals who take on the roles of creditors and debtors. Up to a certain extent, indebtedness is necessary, while policies intended to facilitate the development of the credit market and of retail investments appear in fact as policies promoting indebtedness. Only when the debt stemming from particular sources becomes financially unsustainable, can we speak of over-indebtedness. In those circumstances, the focus must be

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<sup>11</sup> By this it is referred here to both the European Union and the Council of Europe

<sup>12</sup> E. Kempson, ‘Over-Indebtedness and its Causes Across European Countries’, in H.-W. Micklitz and I. Domurath (ed), *Consumer Debt and Social Exclusion in Europe* (Ashgate 2015) 137

shifted from the source of debt, to the ‘cause’ which transforms indebtedness into over-indebtedness.<sup>13</sup> An individual might be indebted because he has concluded a mortgage contract, but he will become over-indebted if he is unable to repay the loan because of, for instance, supervening unemployment. In simplified terms, and using the well-known distinction elaborated by the Bank of France, the impossibility of repaying debts can derive either from financial recklessness – active over-indebtedness – or because of unforeseen causes of major force – passive over-indebtedness. Sociological and statistical data help us identify the most recurring sources and causes of over-indebtedness<sup>14</sup> and it is now widely assumed that passive over-indebtedness plays a more prominent role, though the two dimensions are generally interlinked.<sup>15</sup> The topic has been investigated for several decades, revealing a multidimensional phenomenon, which involves a plurality of sources and causes often of a social origin.<sup>16</sup> Life events like illness, divorce, unemployment, increased costs of renting,<sup>17</sup> are among the main causes of over-indebtedness, which contradicts the popular idea that it is the ‘moral’ fault of the debtor or at least to their ‘economic inadequacy’ that results in their defaulting on their obligations. But if that is true, is over-indebtedness mostly an issue of ‘social law’ to be taken care of by the welfare state rather than contract law? In fact, even if over-indebtedness is triggered by an event, some specific contracts might expose individuals to an increased risk of over-indebtedness and to harsher social consequences than others: the case of payment arrears leading to foreclosures is infamous, and the rest of this contribution will in fact focus predominantly on banking and financial contracts; however it should be noted that even a default on utility bills can expose the debtor to the risk of both over-indebtedness and exclusion from fundamental services like heating and telecommunications.<sup>18</sup> Indeed, statistics show the increasing significance of those expenses, together with tax debt, in the composition of household indebtedness.<sup>19</sup> Thus, the very legal framework might not only represent a possible solution to the problem of over-indebtedness but, if poorly designed, directly contribute to the un sustainability of debt, to the point that it is justified to speak of a legal construction of over-indebtedness. What is, therefore, the legal framework applicable to over-indebtedness?

The introduction has already highlighted a historical correlation between private law principles upholding the debt and exceptional debt relief interventions grounded in a public or, at least, a non-contractual rationality. Building upon that relationship, it is noted that legal re-

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<sup>13</sup> Of course, from an etiological point of view, also the ‘source’ is a concomitant cause of over-indebtedness. What is relevant for our distinction, however, is the event which ‘causes’ indebtedness to turn into over-indebtedness.

<sup>14</sup> E. Kempson, ‘Over-Indebtedness and its Causes Across European Countries’, 137

<sup>15</sup> Banque de France, *Enquête typologique 2007 sur le surendettement*, September 2008, 4

<sup>16</sup> D. Caplovitz, *Consumers in Trouble: A Study of Debtors in Default* (New York, Free Press, 1974)

<sup>17</sup> See Institut für Finanzdienstleistungen, iff-Überschuldungsreport 2018 Überschuldung in Deutschland

<sup>18</sup> On energy debts and over-indebtedness, see P. Rott, ‘Insufficient prevention of over-indebtedness. Legal and policy failures’, in F. Ferretti (ed), *Comparative perspectives of Consumer Over-indebtedness – A view from the UK, Germany, Greece, and Italy* (Eleven Publishing, 2016) 193

<sup>19</sup> Institut für Finanzdienstleistungen, iff-Überschuldungsreport 2018 Überschuldung in Deutschland, 25

sponses to (or, in a constructivist perspective, rather factor in) the problem can be based either in contractual or non-contractual doctrines. The difference does not reside in the categorisation of an intervention as based on private or public law,<sup>20</sup> the difference rather lies in the object of the intervention. Contractual instruments intervene on the contract, i.e. the source of the debt, while non-contractual instruments have a broader scope usually affecting the debt itself rather than its source. Moreover, there are two ways in which those two can operate, i.e. preventively or curatively, leading to a distinction between *ex ante* and *ex post* measures. These two categories intersect giving rise to four categories of legal responses: *ex ante* contractual, *ex ante* non-contractual, *ex post* contractual, *ex post* non-contractual. Given the level of intricacy, the following scheme is meant to bring in some clarity to the issue and provide some obviously non-exhaustive examples of each doctrine - with a particular focus on financial transactions - several of which will be addressed in the following parts.

	<b>Ex ante</b>	<b>Ex post</b>
<b>Contractual</b>	Responsible lending and borrowing, Information duties, Know-your-customer, Product regulation	Termination of contract (frustration, duress, mistake, statutory consumer protections...) Adjustment and re-negotiation
<b>Non-contractual</b>	Financial supervision, Debt advice, Financial education	Debt advice, Consumer insolvency

As a further complication in the European framework,<sup>21</sup> each of these instruments might reside at the supranational and/or at the national level - not to mention the almost certain possibility of intersection and hybridisation of remedies stemming from different regulatory levels. Although it might appear that the choice for one or the other of the two regulatory levels is arbitrary, a peculiarity strikingly emerges from the above scheme, i.e. EU instruments have

<sup>20</sup> Leaving aside the question whether that distinction is in fact convincing.

<sup>21</sup> For a comparative overview of national legal frameworks addressing consumer overindebtedness in light of EU law, see F. Ferretti, R. Salomone, H. Sutschet, V. Tsiafoutis, 'The Regulatory Framework of Consumer Over-indebtedness in the UK, Germany, Italy, and Greece: Comparative Profiles of Responsible Credit and Personal Insolvency Law' (2016) 37(2) *Business Law Review* 64-71 (Part I) and 86-93 (Part II)

so far focused on a mostly *ex ante* contractual dimension, while *ex post* non-contractual measures reside predominantly at the national level. The reason for this distribution is that, constrained by its institutional design, EU legislation has mostly viewed over-indebtedness as the downside of financial access and as a problem to be prevented; historically, referring this task to its member states.<sup>22</sup> However, an evolution within the policy aims of the Union has occurred: since the issuing of the first Consumer Credit Directive,<sup>23</sup> the Commission has funded several studies<sup>24</sup> in order to get a clearer picture of a problem characterised by unclear and discordant definitions adopted at the level of the member states.<sup>25</sup> Recognising a multiplicity of approaches, the European Commission mentioned instruments of both prevention and rehabilitation as possible measures against over-indebtedness.<sup>26</sup> As early as in 2002, the Economic and Social Committee also formulated recommendations<sup>27</sup> for member states and the European Commission, suggesting that a well-functioning internal market justified the harmonisation of both substantive and procedural rules. More recently, the Commission invited the Member States ‘to explore the possibility of applying’ its recommendations on business insolvency procedures to consumers.<sup>28</sup>

More outspoken and comprehensive guidance came from the Council of Europe, rather than the EU. Following-up on the 2005 resolution on ‘Seeking Legal Solutions to Debt Problems in a Credit Society’,<sup>29</sup> the Council of Europe issued a Recommendation on legal solutions to debt problems<sup>30</sup> which outlines a variety of routes, ranging from financial literacy to regulation, to ‘mechanisms necessary to facilitate rehabilitation of over-indebted individuals and families and their reintegration into society’,<sup>31</sup> such as the protection of the essential assets of

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<sup>22</sup> See Consumer Credit Directive 2008/48/EC, recital 26.

<sup>23</sup> Directive 87/102/CEE

<sup>24</sup> N. Huls, U. Reifner, T. Bourgoinie, *Overindebtedness of Consumers in the EC Member States: Facts and Search for Solutions*, 1994; D. Davydoff, G. Naacke, E. Dessart, N. Jentzsch, F. Figueira, M. Rothmund, W. Mueller, E. Kempson, A. Atkinson, A. Finney, *Towards a common operational European definition of over-indebtedness* (European Commission Directorate-General for Employment, Social Affairs and Equal Opportunities Inclusion, Social Policy Aspects of Migration, Streamlining of Social Policies Unit, 2010).

<sup>25</sup> G. Betti, N. Dourmashkin, M.C. Rossi, V. Verma, Y. Yin, *Study of the problem of Consumer Indebtedness: Statistical Aspects Contract n°: B5-1000/00/000197*, final report (Commission of European Union, 2001).

<sup>26</sup> European Commission, *Joint Report on Social Protection and Social Inclusion*, March 2009, 62-63

<sup>27</sup> Opinion of the Economic and Social Committee on Household over-indebtedness, 2002/C 149/01

<sup>28</sup> EU Recommendation of 12 March 2014 C(2014) 1500 final, recital 15

<sup>29</sup> MJU-26 (2005) Resol. 1 Final.

<sup>30</sup> Recommendation CM/Rec(2007)8.

<sup>31</sup> *Ibid.*, 4.



the debtor or measures ‘allowing partial or total discharge of the debts of individuals and, where applicable, families in cases of over-indebtedness where other measures have proved to be ineffective’,<sup>32</sup> therefore interestingly hinting at a possible hierarchy of measures.

Despite the extended range of options available, this catalogue deriving from a combination of national and supranational law does not represent a menu of practically equivalent options from which legislators and judges can arbitrarily choose their favoured meal. Rather, because of the dynamic and multifaceted nature of the phenomenon of over-indebtedness, an effective strategy will require a combination of all instruments, whose proper mixture will depend on the social and economic fabric of the specific context. The various routes will be now introduced, starting from those which are more clearly meant to affect the debt itself rather than its source; hence we will first quickly touch upon non-contractual instrument and, after that, on contractual instruments.

## **Non-contractual instruments**

Non-contractual instruments address over-indebtedness focusing on debt as an economic phenomenon, escaping the strictures of legal doctrines which rather focus on the regulation of the ‘source’ of the debt. This is not to say that non-contractual instruments are necessarily preferable. First, they also present limitations: from the perspective of the debtor, they are available after possibly lengthy and complex procedures and litigations, while from the perspective of the creditor they will irremediably lead to an economic loss. Second, even if non-contractual measures affect the debt rather than the contract, they also entail consequences for the application of contract law doctrines, from which they cannot be detached completely, as will be shown in the second part.

Currently, the two non-contractual instruments which have been discussed more extensively in the literature and which are being promoted in different countries through specific reforms, are programmes aimed at increasing the financial literacy of debtors and, additionally, personal insolvency procedures.

### ***Non-contractual ex ante instruments***

The OECD,<sup>33</sup> the European Union,<sup>34</sup> the Council of Europe, as well as the G20 High Level Principles on Financial Consumer Protection of 2011<sup>35</sup> have all stressed the importance of

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<sup>32</sup> Ibid., 4.h.

<sup>33</sup> See the many working papers available at <http://www.oecd.org/daf/fin/financial-education/oecdfinancialeducationworkingpapers.htm>

improving the financial literacy of consumers implementing financial education programmes through public-private partnerships.<sup>36</sup> The above-mentioned Council of Europe Recommendation even suggested ‘financial literacy on the rights of consumers in general, and budget management in particular, as part of the national education system’.<sup>37</sup> The core idea underlying all these suggestions is, of course, that financially literate individuals will be able to take wiser decisions, while poor financial planning will likely lead into over-indebtedness. This reasoning is particularly widespread in the US where an extensive, though controversial,<sup>38</sup> literature documents a lack of literacy which leads consumers to take unfortunate financial decisions<sup>39</sup> and that therefore might offer a justification for regulation.<sup>40</sup> In the European context, which has embraced financialisation only more recently, the expert group on financial education similarly recognised that ‘the kinds of problems experienced by European consumers have shown that they need very basic skills and knowledge’.<sup>41</sup> Those skills and knowledge appear to be necessary to enhance the effectivity of the disclosure obligations which financial regulation already imposes on services providers: if the consumer is simply unable to fully comprehend the information provided, then the information paradigm which characterises much of financial regulation will be ineffective. That leads to the concern that the approach of European law, focused more on disclosure obligations than on promoting consumer financial literacy, might be unable to protect consumers from their own bad deci-

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<sup>34</sup> White Paper on Financial Services Policy COM(2005) 629. 2004 Green Paper on Retail Financial Services COM(2007) 226 2007 European Parliament resolution on financial services policy P6\_TA-PROV(2007)0338/A6-0248/2007, ECOFIN Council conclusions of 8 May 2007

<sup>35</sup> G20 principles, 4

<sup>36</sup> Second Meeting of the Expert Group on Financial Education, *The financial crisis and financial education. Report*, Brussels, 28th April 2009, 4.

<sup>37</sup> Recommendation CM/Rec(2007)8, 2.b.

<sup>38</sup> T.A. Durkin and G. Elliehausen, ‘Consumer Lending’, in *Handbook of Banking*, 312-325, 316; B. Bucks and K. Pence, ‘Do Homeowners Know Their House Values and Mortgage Terms?’ (2008) 62 *Journal of Urban Economics* 57-70 ; G. Donadio and A. Lehnert, ‘Residential Mortgages’, in *Handbook of Banking* 336

<sup>39</sup> D. Bernheim, ‘Do households appreciate their financial vulnerabilities? An analysis of actions, perceptions, and public policy’ (1995) *Tax Policy and Economic Growth*, American Council for Capital Formation, 1-30; in connection to the issue of overindebtedness, A. Lusardi and P. Tufano, ‘Debt Literacy, Financial Experiences, and Overindebtedness’, *National Bureau of Economic Research*, Working Paper Series, w. 14808, 2009.

<sup>40</sup> An overview in J.Y. Campbell, H.E. Jackson, B.C. Madrian, P. Tufano, ‘The Regulation of Consumer Financial Products: An Introductory Essay with Four Case Studies’, HKS Faculty Research Working Paper Series RWP 10-040, John F. Kennedy School of Government, Harvard University, pp. 9-10

<sup>41</sup> Second Meeting of the Expert Group on Financial Education, *The financial crisis and financial education. Report*, Brussels, 28th April 2009, 2.

sions.<sup>42</sup> If this is true, Moloney suggests that '[t]he resources expended on empowering investors, particularly on the disclosure side, are likely to be misapplied without supporting education strategies'.<sup>43</sup> Legislation has followed suit and the 2014 Mortgage Credit Directive encouraged Member States to 'promote measures that support the education of consumers in relation to responsible borrowing and debt management, in particular in relation to mortgage credit agreements', while the Commission undertakes to assess those measures identifying a set of best practices.<sup>44</sup> If financial information appears to be too difficult to be understood by the average consumer, after having tried to improve the information, the legislator now aims at improving the consumers' knowledge and comprehension.

Despite this emphasis, the role of financial literacy should not be overestimated. In the first place, some consumer rights advocates 'believe that it is not the consumer who should adapt to the financial system but the financial system that should adapt to consumer needs',<sup>45</sup> while a different and more limitative way of understanding financial education – which remains a broad notion which concretely manifests itself in very diverse forms<sup>46</sup> – might lead to that paradigm shift. Moreover, the continuous and quite paternalistic references to the need to educate consumers on how to manage money appear as the behaviouralist re-enactment of the reliance on the information paradigm, now reinforced by the newly emerged macroeconomic justification of achieving financial stability. As it rests upon the assumption that a more educated consumer will be able to take better care of his own interests, the policy of financial education appears as a possibly powerful tool to address the causes of *active* over-indebtedness, but much less so in the case of *passive* one. In fact, while the focus of financial education programmes appears to be on the use of financial services, rather than on money management *per se*, it is therefore quite unlikely that this approach might be effective in helping with frequent causes of over-indebtedness such as illness or divorce. With this in mind, financial education alone cannot be considered as the only policy response to promote a more responsible financial market, not only because it might be not entirely effective, but also because it is ill-equipped to address a considerable part of the problem of over-

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<sup>42</sup> V. Mak and J. Braspenning, 'Errare humanum est. Financial Literacy in European Consumer Credit Law', TISCO Working Paper Series on Banking, Finance and Services, No. 01/2012, p. 5.

<sup>43</sup> N. Moloney, *How to Protect Investors. Lessons from the EC and the UK* (Cambridge, Cambridge University Press, 2010), p. 389.

<sup>44</sup> Directive 2014/17/EU, Art. 6

<sup>45</sup> U. Reifner and A. Schelhowe (2010) 'Financial Education' 9 (2) *Journal of Social Science Education* 32 – 42, 33

<sup>46</sup> *Ibid.* 32 – 42

indebtedness. This aspect has been touched upon also by the expert group on financial education, remarking that financial education cannot be regarded as a substitute for regulation.<sup>47</sup>

### ***Non-contractual ex post instruments***

Emergency measures both at the EU and the national levels have attempted to tackle the systemic problem posed by excessive indebtedness of banks. With regard to household over-indebtedness, several countries have amended their legislation in order to introduce new and exceptional mechanisms to cope with consumer debt. This represented a significant event as those procedures were generally reserved to commercial debtors based on the assumption that only commercial insolvencies posed a systemic risk to the economy and, as such, justified specific procedures taking into account the interests of all creditors.<sup>48</sup> Though mechanisms of consumer bankruptcy emerged in the 80s,<sup>49</sup> it is noteworthy that the financial and economic crisis has led to an acceleration and spread of those models, producing a second wave of personal bankruptcy legislation in Europe. One could mention, quite paradigmatically, the law reforms which took place in Greece in 2010, in 2011 in Iceland,<sup>50</sup> as well as in 2012 when consumer bankruptcy laws were either introduced or reformed in Portugal, Spain, Italy, and Ireland. Although in some instances the necessity of introducing personal insolvency regimes was recognised in the early 2000s, when different financial scandals produced significant losses for retail investors,<sup>51</sup> the legislative lag resulted from political reasons and, more fundamentally, the particular economic fabric of those societies, in which household indebtedness traditionally played a less prominent role than private saving. The necessity of debt relief mechanisms for civil debtors was felt less urgently than in countries with a more widespread financial retail system. Quite understandably, crisis-hit countries, which had to quickly introduce emergency measures, tended to adopt the most far reaching *ex post* non-contractual instruments, such as personal insolvency, rather than preventive measures.

These systems include, most importantly, debt adjustment or debt discharge procedures, either judicial or extra-judicial or more often a combination of both. Solutions in this regard are quite diverse and well documented in an already rich literature.<sup>52</sup> It suffices to recall that, be-

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<sup>47</sup> Second Meeting of the Expert Group on Financial Education, *The financial crisis and financial education. Report*, Brussels, 28th April 2009, 3.

<sup>48</sup> See Italian Constitutional Court: C. Cost., 23 March 1970, n. 43; C. Cost., 16 June 1970, n. 94

<sup>49</sup> J. Ziegel, 'The Challenges of Comparative Consumer Insolvencies' (2004-2005) 23 Penn St. Int'l L. Rev. 639

<sup>50</sup> The particularly dramatic socio-economic background is described in E. Méndez Pinedo, *La Revolución de los Vikingos. La victoria de los ciudadanos, las lecciones del modelo islandés para superar la crisis en España* (Barcelona: Planeta, 2012)

<sup>51</sup> See for Italy, G. Presti, I. Stanghellini, F. Vella (eds.), *L'insolvenza del debitore civile. Dalla prigionia alla liberazione. Analisi Giuridica dell'economia 2/2004* (Bologna, Il Mulino, 2004)

<sup>52</sup> K. Anderson, 'The Explosive Global Growth of Personal Insolvency and the Concomitant Birth of the Study of Comparative Consumer Bankruptcy: Consumer Bankruptcy in Global Perspective', by Johanna Niemi Kiesi-

sides the plurality of solutions elaborated and which to a certain extent appear to respond to different political economic views,<sup>53</sup> at least in Europe one can identify some common features in these schemes. We will return to some of these features in the following pages, but first it will be necessary to shift the focus from the instruments through which the debt is tackled to those instruments which intervene on the source of the debt itself.

## Contractual instruments

European contract law lacks a single, general doctrine to address over-indebtedness. The reasons for this are historical and inherent to the very concept of a contract as an economic transaction. The system of private law values the principle of self-responsibility as a manifestation of private autonomy, which holds particularly true with respect to the economic contents of the contract. The issue which needs to be corrected by law does not lie in the excessive debt itself, which is something that as a rule of thumb the law leaves to the contracting parties themselves to evaluate, but rather in its possibly unfair or non-consensual source. Exceptions tend to be rare and usually linked to situations which, where recognised, are so invidious they can even amount to crimes, such as in the notable case of usury. Self-responsibility remains the theoretical starting point even in the way in which the literature interprets those rules which can perform an anti-over-indebtedness function. Creditworthiness assessment rules, as an example, are construed as a safeguard of the free will of the party, which on the other hand raises the question whether a lender has a duty to inform whenever a loan could negatively impact the quality of life of the borrower,<sup>54</sup> or whether that duty has to be narrowly construed in light of the principle of self-responsibility.<sup>55</sup>

Even if one accepted that one of the functions of contract law should be the prevention or cure of over-indebtedness, nonetheless, this still does not imply that this branch of the law is sufficiently well-placed to attain that goal. The problem appears to be that, as over-indebtedness is a dynamic process arising from a plurality of relations with several counterparts, contract law can mostly affect each of those relations individually. Unlike insolvency procedures characterised by their necessarily collective nature involving all creditors, contract law is structurally unable to view over-indebtedness as a collective phenomenon. While

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lainen, Iain Ramsay & William C. Whitford (eds.); *Comparative Consumer Insolvency Regimes: A Canadian Perspective*, by Jacob S. Ziegel' (2004) 42 *Osgoode Hall Law Journal* 661-680; I. Ramsay, *Personal Insolvency in the 21st Century. A Comparative Analysis of the US and Europe* (Oxford, Hart, 2017)

<sup>53</sup> I. Ramsay, 'Between Neo-Liberalism and the Social Market. Approaches to Debt Adjustment and Consumer Insolvency in the EU' (2012) 35(4) *Journal of Consumer Policy*, 421–41

<sup>54</sup> C. Wendehorst, 'Was ist Bonität? Zum Begriff der "Kreditwürdigkeit" in § 7 VKrG' in B. Blaschek and J. Habersberger (eds), *Eines Kredites würdig?* (Vienna, Verlag Österreich) 19–37, 25

<sup>55</sup> E. Heinrich, *Bonitätsprüfung im Verbraucherkredit. Kreditwürdigkeit, Warnpflicht und Sanktionen bei Pflichtverletzung im österreichischen und deutschen Recht* (Vienna, Manz, 2014) 91

it is ill-placed to cope with the debt once it has arisen, since its *ex post* interventions are limited to its capacity to invalidate or amend existing contracts, contract law can nonetheless determine the way in which debt arises, as the source of the monetary obligation. Interestingly, this aspect can both represent a constraint and offer room to manoeuvre: regulation of specific contract types might allow for more accurate fine-tuning to the necessity of the over-indebted party. For instance, having found that one particular contract type is statistically more likely to lead to over-indebtedness - as obviously occurs with credit agreements - a stricter regulation of that agreement might reveal more effective than generic preventive rules indiscriminately affecting all contract types. Because of this, it is now convenient to focus mostly on some contracts only, i.e. banking and financial contracts, despite the fact that over-indebtedness usually stems from very different contractual relations. In what ways, then, may contract law intervene?

### ***Contractual ex ante instruments***

Contract law can prevent over-indebtedness through at least two strategies. The first regulatory one consists in setting restrictions to potentially dangerous obligations that parties can negotiate - examples include interest rate caps as well as regulation of the criteria through which interest is calculated, notably including the permission or prohibition of compound interest. The second information-based approach consists in making contracting parties aware of the consequences that might derive from the contract, typically by way of information duties backed either by sanctions or by a set of incentives and disincentives meant to produce the intended result ('nudges', as they are nicknamed in the behaviouralist perspective of 'liberal paternalism').<sup>56</sup> As touched upon, this latter approach is believed to be more likely to succeed when associated with financial literacy policies. EU contract law has traditionally favoured this strategy,<sup>57</sup> but it is only in the aftermath of the financial crisis<sup>58</sup> that the approach has gained teeth, with the expansion of the responsible lending principle in mortgage contracts.<sup>59</sup> If the new rules on mortgage credit rest, in part, on a different rationale to the more liberal (and resulting from a compromise between opposite views)<sup>60</sup> ones of the 2008 Consumer Credit Directive, the difference appears justified by the further systemic and social

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<sup>56</sup> R.H. Thaler and R. Sunstein, *Nudge. Improving Decisions about Health, Wealth, and Happiness* (New Haven, Yale University Press, 2008)

<sup>57</sup> For the development of the policies of the consumer credit directives, see I. Łobocka-Poguntke, *The Evolution of EC Consumer Protection in the Field of Consumer Credit* (Pieterlen, Peter Lang, 2012)

<sup>58</sup> Y.M. Atamer, 'Duty of Responsible Lending: Should the European Union Take Action?' in S Grundmann and Y.M. Atamer (eds) *Financial Services, Financial Crisis and General European Contract Law. Failure and Challenges of Contracting* (Alphen aan den Rijn, Kluwer) 179–202

<sup>59</sup> O. Cherednychenko, 'Freedom of Contract in the Post-Crisis Era: Quo Vadis?' (2014) 10 *European Review of Contract Law* 390–421

<sup>60</sup> EF Pérez Carrillo and F Gallardo Olmedo (2014) 'The EU Consumer Credit Directive 2008 in the light of the EuSoCo Principles' in L Nogler and U Reifner (eds), *Life Time Contracts: Social Longterm Contracts in Labour, Tenancy and Consumer Credit Law* (The Hague, Eleven Publishing) 312–30

risk posed by mortgage debt. The choice for a regulatory or a liberal strategy appears, then, to be determined by considerations drawn from risk regulation which take into account the seriousness of over-indebtedness.

Forms of intrusive interventions on the contract itself, comparable to forms of product regulation, have been less evident in the case of consumer credit where duties to inform have on the contrary been employed, while they are more developed with regard to retail investment products. The economic rationale underlying the reforms is evident comparing the three relevant fields: responsible lending and know-your-customer obligations are particularly relaxed in the case of consumer credit, stricter in the case of mortgages (which can entail consequences such as evictions) and particularly intrusive in the case of investment products (which can be detrimental both to the consumer and the financial system). Following this reading, systemic risk represents one of the considerations behind policy choices regarding over-indebtedness.

### ***Contractual ex post instruments***

Once a detrimental contract has been entered into, despite all the preventive rules which have been mentioned, how to deal with the possibly excessive debt arising from it? While the above-described *ex ante* measures are mostly of an EU origin and their rationale is rooted in (various degrees of) financial regulation, there is much less from the supranational level in terms of *ex post* contractual instruments, which are largely based on general contract law and therefore a national competence all the more after the unsuccessful codification attempts at the EU level. Nevertheless, even doctrines based on EU law have been used to seek relief for excessively indebted consumers, as the case of the Unfair Terms Directive abundantly and paradigmatically demonstrates:<sup>61</sup> while it embodies principles which make it unfit to challenge terms leading to over-indebtedness if they are not also unfair<sup>62</sup> and does not straightforwardly help against core terms, the directive, occasionally read in light of fundamental rights, has helped triggering through the Court of Justice of the EU a reform of national procedural mechanisms to the avail of over-indebted consumers, proving the relevance of contract law even for designing effective non-contractual instruments. Leaving aside the well-known events following the celebrated *Aziz* case<sup>63</sup> and rather looking at national law, it is noted that in the wave of cases linked to the financial crisis, the doctrines which have been employed or tested - even if not always successfully - by the judiciary include good faith in continental Europe, (the lack of) *causa* specifically in Romance systems, as well as equitable

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<sup>61</sup> H.-W. Micklitz and N. Reich, 'The Court and Sleeping Beauty: The revival of the Unfair Contract Terms Directive (UCTD)' (2014) 51(3) *Common Market Law Review* 771–808

<sup>62</sup> I. Domurath, *Consumer Vulnerability and Welfare in Mortgage Contracts* (Oxford, Hart, 2017) 104

<sup>63</sup> H.-W. Micklitz and N. Reich, 'The Court and Sleeping Beauty'

doctrines such as undue influence in English law.<sup>64</sup> All those doctrines allow for the invalidation of an agreement because of a flaw in the contract design or in the negotiation phase, thus for causes which can be considered endogenous to the contractual relation itself, temporarily prior or concomitant to it. As such, they focus on ‘sources’ but are less capable to catch the ‘cause’ of over-indebtedness as directly linked to exogenous and supervening phenomena. The most notable exception, which has in fact been discussed in literature as a possible contractual alternative to other instruments against over-indebtedness, is the ‘change of circumstances’ or ‘frustration’ doctrine, as an expression of an overarching *rebus sic stantibus* principle.<sup>65</sup> As is well-known, the principle, legislatively or doctrinally accepted in most countries even though with differences,<sup>66</sup> allows for a contract to be terminated or amended when there has been a fundamental change of circumstances such that presumably the parties would have not agreed to the terms had they known in advance of that circumstance.

Hence, while previously discussed policies like financial literacy seem to predominantly address active over-indebtedness, the fact that change of circumstances involves an external and unforeseen event makes that doctrine theoretically appealing as an instrument to address passive and thus non-negligent over-indebtedness. Nevertheless, inasmuch as it allows for a deviation from the *pacta sunt servanda* principle, the doctrine is subjected to strict qualifications in most jurisdictions, so that its application to situations involving over-indebtedness - at least one stemming mostly from financial contracts - is often virtually excluded. The major obstacle to the application of the principle is the requirement that the event leading to the change of circumstances be exogenous to the conduct of the parties, unforeseen and unforeseeable - an ‘act of God’ in the traditional common law terminology - unforeseen and unforeseeable, even if different jurisdictions have shown different sensibilities on the evaluation of that unforeseeability. Could the ‘cause’ of over-indebtedness be foreseen? If active over-indebtedness is necessarily excluded by this requirement, the fundamental question becomes whether passive over-indebtedness determined by event such as economic and debt crises could on the contrary be embraced by the doctrine, considering the crisis as an overwhelming and unforeseeable factor which makes the performance of the contract according to the original terms impossible. Hence, foreseeability should concern the event leading to over-indebtedness rather than over-indebtedness itself.

This is not a purely theoretical question, as on the contrary the possibility of invalidating retail investment and credit contracts in reason of the recession has been tried in several coun-

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<sup>64</sup> R. Momberg Uribe, ‘Beyond the Risk: Swaps, Financial Crisis and Change of Circumstances. Comparative Case Note. Supreme Court of Portugal – 10.10.2013. Conclusions’ (2015) 23 *European Review of Private Law*, 151

<sup>65</sup> J. Pulgar, ‘A contractual approach to overindebtedness: rebus sic stantibus instead of bankruptcy’, in L. Nogler and U. Reifner (eds), *Life Time Contracts. Social long-term contracts in labour, tenancy and consumer credit law* (The Hague: Eleven International Publishing, 2014) 534; J. Pulgar, ‘La protección contractual del sobreendeudamiento del consumidor hipotecario’ (2014) 291 *Revista de derecho mercantil* 207-232

<sup>66</sup> See E. Hondius and H.C. Grigoleit (eds), *Unexpected Circumstances in European Contract Law* (Cambridge: Cambridge University Press, 2011)



tries but rarely has it led to beneficial consequences for indebted consumers except than in the remarkable case of Portugal. There, a swap contract was terminated because the financial crisis was controversially considered by the Court ‘in no way foreseeable’,<sup>67</sup> making the contract contrary to the requirement of good faith. A later comparative analysis focused on the facts of the Portuguese case confirmed that such an approach is unlikely to be effective in any other European country, so that the Portuguese solution appears more like a debatable exception than a viable alternative.<sup>68</sup> Broadening our view, the same seems to hold true in the American common law, where courts have also denied that the recession allows a borrower to delay the payment of monthly instalments due under commercial contracts.<sup>69</sup> Only in Nordic jurisdictions, a form of ‘social *force majeure*’ has been long recognised expanding on the traditionally restrictive approach to change of circumstances, as an instrument which might help indebted debtors in trouble to be released from excessive debts.<sup>70</sup>

Thus, are *ex post* contractual instruments of little or no use in the fight against household over-indebtedness? Not necessarily. If it is true that the judicial practice is almost universally restrictive, a certain interpretative leeway might still exist: in order to apply the doctrine of change of circumstances, the distinction between the source and the cause of over-indebtedness which has been drawn earlier becomes crucial and has not always been sufficiently considered in judicial applications. With regard to the ‘sources’ of over-indebtedness, the principle of *rebus sic stantibus* is not relevant to all contractual relations: application is limited to contracts which are not of an aleatory nature, which almost constantly excludes derivative contracts<sup>71</sup> - but does not rule out other contract types. With regard to the ‘source’ of over-indebtedness, and thus the events leading to the change of circumstances, this limitative approach taken by interpreters and courts who insist that a financial crisis is not an unforeseeable event seems problematic. To be sure, economists have shown that financial crises can be expected and are to a certain extent even unavoidable<sup>72</sup> - which would make it more arduous to consider them completely unforeseeable in a legal perspective - but a very different task is to foresee when and how a crisis will occur impacting on private relations. More importantly still, the financial crisis is just one of the elements of a series of events which can lead to worsened macroeconomic circumstances and thus to a change of circumstances. Even accepting that a financial crisis can be theoretically foreseen, less foreseeable might be the

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<sup>67</sup> Supremo Tribunal de Justiça, 10 October 2013.

<sup>68</sup> See the contributions by R. Momberg, J.C.M. Dastis, D. Philippe, S. Lequette, R.E. Cerchia, J.P.M. Fernández in *European Review of Private Law*, Volume 23 (2015)

<sup>69</sup> One case has notably involved the current US President Donald Trump. The story is narrated in L.A. Cunningham, *Contracts in the real world. Stories of popular contracts and why they matter* (Cambridge University Press, 2016) 81-85

<sup>70</sup> T. Wilhelmson, *Critical Studies in Private Law* (Dordrecht: Kluwer, 1992)

<sup>71</sup> Of course as long as the unforeseeable event affects the typical risk of that contract.

<sup>72</sup> H.P. Minsky, ‘The Financial-Instability Hypothesis: Capitalist Processes and the Behavior of the Economy’, in C.P. Kindleberger and J.-P. Laffargue (eds), *Financial Crisis: Theory, History, and Policy* (Cambridge University Press, 1982) 13-39

further consequences in terms of ‘economic crisis’, possibly deriving from a combination of elements such as the financial crisis itself, economic recession, inappropriate political responses to it, unemployment and wage cuts and so on, which in the end result in the impossibility of repaying debts.

It is worth noting that this line of reasoning already has received some judicial favour in commercial cases. In Spain, the Supreme Court stretched the traditionally limited approach to change of circumstances, admitting that the economic crisis might legitimise the application of the doctrine, also referring to transnational private law as evidence supporting the new approach.<sup>73</sup> More recently, and confirming its approach taken in 2013, the Court stated that ‘the current economic crisis, with deep and prolonged effects of economic recession, can plainly be regarded as an economic phenomenon capable to determine a serious disturbance or change of circumstances’.<sup>74</sup> In the light of this, the Court admitted the renegotiation of the economic contents of an advertisement contract - thus, importantly, not an aleatory one - after the economic crisis led to severe losses for one of the parties, which lost a considerable part of its usual business. The Court attempted to play down the novelty and potential theoretical implications of its decision by underlining that this reasoning does not represent a breach of the *pacta sunt servanda* principle but is rather coherent with the principles of commutative justice and good faith – which incidentally leads to the question whether the same approach could successfully be employed in jurisdiction where the principle of good faith appears to play a less prominent role.

## The interrelation among the instruments

Confronted with this plurality of options available to counteract consumer over-indebtedness, the question might arise as to what is the optimal approach. That is not a question that can be answered in the abstract. First, each instrument has to be considered against the background of economic and social policy: depending on the particular social fabric, the law may favour preventive contractual instruments, which limit the availability of financial products to citizens, or curative non-contractual measures, which relieve debtors resulting in losses for creditors. At least in part, the solution depends on the answer to another question, i.e. what is the trade-off between debtor protection and losses that the creditor can and should bear? That

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<sup>73</sup> Tribunal Supremo, N° de Resolución: 333/2014, 30 June 2014. See P. Abas, ‘Il tribunale supremo spagnolo ammette la revisione del contratto in caso di sopravvenienza contrattuale’ (2015) *Rivista di diritto civile* 1194-1197

<sup>74</sup> Full quotation: Esta tendencia hacia la aplicación normalizada de esta figura, reconocible ya en las Sentencias de esta Sala de 17 y 18 de enero de 2013 (núms. 820 y 822/2012, respectivamente) en donde se reconoce que la actual crisis económica, de efectos profundos y prolongados de recesión económica, puede ser considerada abiertamente como un fenómeno de la economía capaz de generar un grave trastorno o mutación de las circunstancias, también responde a la nueva configuración que de esta figura ofrecen los principales textos de armonización y actualización en materia de interpretación y eficacia de los contratos

is ultimately the reason why the original question as to what instruments are preferable cannot be answered once and for all, as it involves political economic considerations which appear to be too context-dependent. A tentative answer will have to be left to another occasion, keeping in mind that all measures against over-indebtedness come with a cost that must be allocated. Second, the various instruments are not interchangeable; rather, they are interrelated, so that their use will necessarily reflect on the applicability of other measures. To put this interrelation more clearly by way of an example: it has been mentioned that stricter preventive rules characterised by a stronger regulatory approach are employed in the case of financial services. This regulatory choice is made more compelling by the fact that, if over-indebtedness were to arise as a consequence of the conclusion of a derivative contract, it would be nearly impossible to resort to curative measures such as the change of circumstances doctrine, in light of the above-mentioned limitations. Those transactions present a double level of risk (at least for the debtor): a financial risk and a legal risk, since the number of options available to help the over-indebted customer would be limited. The overall deficiency of general contract law in its *ex post* functionality must therefore be compensated by the stronger *ex ante* approach to certain financial transactions. The difficulty of applying a class of instruments puts pressure on the other available instruments. Conversely, this balance requires that whenever product regulation is weaker, i.e. in the case of credit and less so mortgage credit but also in the case of non-financial contracts, legal responses must become stronger *ex post* - in fact, some limitations to the change of circumstances doctrine would not be an obstacle to the invalidation of non-aleatory contracts. Normatively, it could even be imagined that the *rebus sic stantibus* principle could be interpreted somewhat more generously in cases of passive over-indebtedness determined by consumer and mortgage credit contracts, as those agreements are shielded by less stringent *ex ante* instruments.

Other interrelations between *ex ante* and *ex post* instruments remain nonetheless more problematic and financial literacy measures, in particular, impact on the application of *ex post* measures. In the next three sections, different modes of interrelation between the measures will be sketched.

### ***Contract law and financial literacy***

The ruling of the Portuguese Supreme Court allowing for the termination of a swap contract frustrated by a change of circumstances has already been mentioned as an instance of application of an *ex post* contractual measure. At the same time, that ruling has been criticised on doctrinal grounds because of its debatable interpretation of notions of foreseeability and risk. To be fair, and on a second glance at the Portuguese case-law, the judgment did not lead to a generalised extension of the applicability of change of circumstances to risky financial products beyond the case of the protection of a financially illiterate citizen. Lower courts appear to still adopt a restrictive approach in considering the foreseeability of financial crises,<sup>75</sup> lead-

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<sup>75</sup> 'Tribunal de Paredes rejeita anular contrato swap feito com BES', *Publico*, 21 September 2014

ing to frictions with the approach of the Supreme Court.<sup>76</sup> It makes sense, however, to go beyond the dogmatic analysis of the ratio of the decision and rather focus on the facts of the case, which are clearly and meaningfully outlined in the decision itself. As both the lower and the higher Portuguese court stated, clarifying the circumstances under which the contract was entered into, ‘the plaintiff merely limited herself to sign the contract and nothing was read to her or explained to her. The legal representative of the plaintiff is a very simple person, who just has a basic education and never contracted any special or complex financial product with banks, while the plaintiff never realised that the contract she was signing could entail any risk and, consequently, a considerable loss’. What emerges from this quote is primarily the intention to protect an unexperienced and unskilled user of financial services who, even without necessary qualifying as a consumer, completely lacked any financial literacy. This supports the intuition of Momberg that, rather than change of circumstances, ‘the existence of intrinsic or legal information duties, the complexity of the financial products and the (non-) sophistication of the client appear to be the main factors on which legal doctrine and the courts have relied to award damages or to terminate swap contracts’.<sup>77</sup>

This is a telling aspect if placed into a comparative perspective: the way in which the Portuguese Court construed the investor as an inexpert subject is in fact not dissimilar to the approach taken by many other European courts to allow for the application of different doctrines, even including constitutional provisions,<sup>78</sup> to the benefit of the weaker party. Whereas it remains very debatable whether a subjective element such as the lack of expertise of the investor can be usefully employed to interpret the objective element of the foreseeability of an event such as a financial crisis, that lack of expertise has in fact played a role in the application of other doctrines. By these lights, while the Portuguese decision might be surprising to the extent that it applied change of circumstances to a derivative contract, it is by no means exceptional taking the different perspective of financially weaker party protection. The main question therefore shifts from the doctrinal correctness of resorting to change of circumstances (an analysis which would necessarily have to be based on the particular national legal categories) to the more fundamental issue of under which conditions and to what degree financial literacy should be taken into account while protecting the debtor.

Financial illiteracy is often used as a concomitant argument to invalidate contracts based on several doctrines,<sup>79</sup> while courts appear to be much less responsive to the complaints of financially educated and sophisticated claimants. When the claimant is a sophisticated investor

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<sup>76</sup> The Portuguese law on the applicability of change of circumstances to swap contracts has been considered also by English courts: *Banco Santander Totta SA v Companhia Carris De Ferro De Lisboa SA* [2016] EWCA Civ 1267

<sup>77</sup> R. Momberg, ‘Beyond the Risk’ 151

<sup>78</sup> O. Cherednychenko, *Fundamental Rights, Contract Law and the Protection of the Weaker Party. A Comparative Analysis of the Constitutionalisation of Contract Law, with Emphasis on Risky Financial Transactions* (Munich, 2007)

<sup>79</sup> The low educational level in general concurs to delineate a form of ‘relational vulnerability’, see I. Domurath, *Consumer Vulnerability and Welfare in Mortgage Contracts* (Oxford, Hart, 2017)

and an advisory relationship has not been explicitly entered into by the parties, English courts usually refrain from concluding that there has been a breach of a duty of care or that the contract can be rescinded for mistake,<sup>80</sup> sometimes and controversially even forcing protective statutory provisions,<sup>81</sup> whereas radically different outcomes can be reached when that level of sophistication is not present and the plaintiff appears to be ‘very naive and inexperienced about money matters’.<sup>82</sup> The approach of continental courts especially in countries most affected by the crisis appears to be sensitive to the degree of financial literacy of the claimant as well, as has become visible in a recent case-law concerning the miss-selling of harmful financial products to retail investors. As shown by Della Negra’s comparative analysis on the subject,<sup>83</sup> the Spanish Supreme Court on different occasions refused to terminate for mistake a retail investment contract concluded by an experienced investor who appeared to have understood the risk assumed, while it acknowledged that a similar contract concluded by a small firm whose director lacked financial expertise could be terminated for mistake as the bank did not perform suitability and appropriateness tests as required by regulations.<sup>84</sup> Rather than the formal qualification of a party as a ‘consumer’, what matters here is the degree of financial literacy, so that the ‘financial consumer’ appears to be different from the ‘consumer’ *tout-court*. That comparative analysis also points out that French courts undertake similar assessments as to the concrete capacity of the investor to understand the risks associated with the contract they are signing, concluding that clients who are familiar with financial products because of their own trade or profession might be regarded as having a sufficient financial expertise to understand the contract.<sup>85</sup>

Without repeating points already developed in those analyses, it suffices to note that while the concretely applicable doctrine can vary in different jurisdictions, financial illiteracy always comes into the picture as an element which delineates the figure of the weaker investor. What is much less considered is the question as to how the envisaged programmes of financial education might impact on legal reasoning and on the applicability of contract law doctrines and benchmarks such as the reasonably circumspect consumer. There is in fact an alternative and less optimistic reading of the interaction between financial literacy and contract law: besides more general policy concerns that programmes of financial literacy ‘from above’

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<sup>80</sup> *JP Morgan Chase Bank v Springwell Navigation Corp* [2010] EWCA Civ 1221

<sup>81</sup> D. Maffei, ‘Italian and English judgments regarding over the counter derivatives’ (2013) 26 *Rivista di diritto bancario*, [dirittobancario.it](http://dirittobancario.it)

<sup>82</sup> *Verity & Spindler v Lloyds Bank plc* [1995] CLC 1557, 1580. For a restrictive interpretation of the case, see E.P. Ellinger, E. Lomnicka, C.V.M. Hare, *Ellinger’s Modern Banking Law* (Oxford University Press, 2011) 160; also P. Hood, *Principles of Lender Liability* (Oxford University Press, 2012) 199

<sup>83</sup> F. Della Negra, *MiFID II and Private Law Enforcing EU Conduct of Business Rules* (Oxford, Hart Publishing, 2019)

<sup>84</sup> *Ibid.*

<sup>85</sup> *Ibid.*

in fact have a de-politicising effect on finance,<sup>86</sup> one could also wonder whether the outlined approach of European national courts could still be employed when more widespread programmes of financial education would place the investor, at least formally, on the same informational level as the financial services provider. Would that consumer still be protected as ‘financially illiterate’? The further risk arises that, in defining the level of financial literacy of the retail investor, the mere fact that he has been financially educated might be sufficient to qualify him as financially literate, thereby depriving him of that protection which could otherwise be offered by general doctrines.

Hence, the still unfolding relation between financial literacy and contract law can be evaluated in two opposite ways. As a first possibility, a more informed consumer will not end up in over-indebtedness so that there will not be the need for *ex post* contractual and non-contractual instruments. This is the optimistic view supported by the European Commission, which considers that financially literate individuals ‘are less likely to purchase products they do not need, be tied into products that they do not understand, or take risks that could drive them into financial difficulty’.<sup>87</sup> In this sense, the strict approach of contract law with regard to doctrines like the change of circumstances will remain socially sustainable as financial education intervenes in the background. As a second and a less favourable scenario for consumers, over-indebted individuals who have nonetheless been at least formally financially educated might encounter increased difficulties in being relieved through *ex post* contractual measures. In order to avoid counterproductive effects, the evaluation of literacy will have to be performed on an individual and concrete basis rather than in abstract relying on, for example, the mere attendance of financial literacy programmes possibly introduced in schools as is being internationally advocated as a panacea.

### ***Financial literacy and personal insolvency***

An analogous concern to the one mentioned in the previous section regards the relation between financial literacy and personal insolvency procedures. An interesting characteristic of the legislation on the issue is that an over-indebted individual will be able to enjoy a so-called ‘fresh start’ after a certain period of time at the end of the insolvency procedure only under certain conditions, which can notably include the requirement to follow financial literacy programmes. The most remarkable and outspoken example of this approach is offered by US law, where the much debated 2005 reform intended to limit the recourse to debt discharge required debtors seeking relief to follow a financial management instructional course. The idea is that ‘a financial management training curriculum and materials [...] can be used to

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<sup>86</sup> S. Daellenbach, ‘Who’s Afraid of Public Financial Literacy?’, in M.A. Peters, J.M. Paraskeva, T. Besley (ed), *The Global Financial Crisis and Educational Restructuring* (New York, Peter Lang, 2015) 250

<sup>87</sup> COM(2007) 808 final, 4

educate debtors who are individuals on how to better manage their finances'.<sup>88</sup> The policy rationale is that the reason why the debtor necessitated that procedure in the first place was poor capacity to manage their own finance, so that financial education will decrease the need of similar interventions in the future. This approach might be justified by the empirical finding that, in the US, one consumer out of four still faced difficulties in paying their dues already one year after the conclusion of the debt relief procedure.<sup>89</sup> At the same time, it might be wondered how much indebtedness is due to the lack of financial capacity of debtors who persist in bad management of their own finance, and how much depends on external factors over which the debtor has little or no control. In this sense, financial literacy possibly reinforces the idea of over-indebtedness as an active phenomenon downplaying the possible existence of structural reasons for indebtedness.

Although not in the clear terms employed in America, financial literacy appears to play a role also in European consumer bankruptcy legislations.<sup>90</sup> Here, nonetheless, rather than financial education per se as a preventive educative policy, legislation is more likely to refer to debt counselling and debt advice, more specific programmes which help already indebted consumers to better deal with their deteriorating financial conditions. Because of the variety of debt counselling mechanisms existing in Europe, it is hard to identify some general features of those services, as they tend to be quite flexible in order to be able to support a debtor in different moments. As summarised by Niemi-Kiesilainen already at the end of the 90s, although European consumer bankruptcy laws 'do not usually explicitly require the debtor to receive counselling before filing for consumer bankruptcy', they do require 'the debtor to have made a good faith proposal to the creditors to settle the debts before filing for bankruptcy. In practice, the legal requirements for an acceptable proposal are so complicated that the debtor needs professional assistance.'<sup>91</sup> In some legislation on the subject, the role of those services has evolved into panels within public bodies conferred with a mandate to help the consumer elaborate a plan and support him during the procedure. This is the model now adopted by Italian legislation,<sup>92</sup> which promotes the creation of 'Crisis Settlement Boards' with various functions including legal and financial advisor to the debtor. In several countries, the lack of independent debt advisers to help consumers in out-of-court procedures has been identified as a practical hindrance making it harder for individuals to have their debt dealt with effectively.<sup>93</sup>

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<sup>88</sup> Bankruptcy Abuse Prevention and Consumer Protection Act, Sec 105(a)

<sup>89</sup> KM Porter and D Thorne, 'The Failure of Bankruptcy's Fresh Start' (2006) 92 *Cornell Law Review* 67-128

<sup>90</sup> J. Niemi-Kiesilainen, 'The Role of Consumer Counselling as Part of the Bankruptcy Process in Europe' (1999) 37 *Osgoode Hall L.J.* 409

<sup>91</sup> *Ibid.*, 412

<sup>92</sup> G. Comparato, 'The Italian Law against Over-Indebtedness. Fresh start, debt advice, and financial education', in F. Ferretti (ed), *Comparative perspectives of Consumer Over-indebtedness – A view from the UK, Germany, Greece, and Italy* (Eleven Publishing, 2016) 373-392

<sup>93</sup> M.J. Mouzouraki, '(Failure to Set Up an Efficient) Out-Of-Court System to Deal With Debtors in Financial Distress in Greece' in F Ferretti (ed), *Comparative Perspectives of Consumer Over-indebtedness—A View from the UK, Germany, Greece, and Italy* (The Hague, Eleven Publishing)

It is worth noting that while policies of financial education might still not be optimal while combined with bankruptcy procedures, debt counselling services might on the contrary be more effective when employed immediately before debt becomes socially unsustainable and the debtor opts for the insolvency route. That appears to be particularly the case when debtors are in arrears and might face the risk of foreclosure. Attempting to set new guidelines that credit institutions should follow while dealing with debtors in trouble, the ‘Consumer Credit Sourcebook (CONC)’ by the Financial Conduct Authority in the UK states that whenever a debtor appears to be in arrears, the firm should inform the consumer, as part of its obligation to treat him fairly, that ‘free and impartial debt advice is available from not-for-profit debt advice bodies’ and direct him to those bodies.<sup>94</sup>

### ***Personal insolvency and contract law***

Because of a series of fundamental differences which have been tentatively explained both on economic and cultural grounds,<sup>95</sup> the European approach to *ex post* non-contractual mechanisms seems less extensive than the one of the US. If those procedures are examined taking into account also the contractual background of indebtedness, a further multiplication of obstacles to debt relief seems to emerge. Legislators admit only good faith debtors for the discharge of debts. The case of consumer and mortgage credit can be taken here as an example: the mortgage debtor applying for debt relief will have to be screened for her worthiness twice: initially by the financial services provider before credit is given, as part of the preventive responsible lending measures, and secondly by a judge - or possibly by governmental insolvency services - when the *ex post* procedure is resorted to (the concrete moment in which this screening will be performed of course depends on the design of the particular law). As an example of the problems posed by this interaction we can consider Italy, a country which, as already mentioned, introduced consumer bankruptcy legislation after long discussions in 2012 under the pressure of the financial crisis.<sup>96</sup> The law contains several references to the general regime regulating consumer credit, stating for instance that the consumer plan of debt adjustment can pose limitations on the use of financial services by the debtor. More importantly, the law establishes that debt relief can be granted by a judge only after it has been ascertained that over-indebtedness does not derive from a negligent or disproportionate use of credit.<sup>97</sup> Thus, the law obliges the judge to perform a kind of ‘debt relief worthiness assessment’ which somewhat resembles a belated credit worthiness assessment: it

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<sup>94</sup> CONC 7.3.7A

<sup>95</sup> A discussion in J. Spooner, ‘Fresh Start or Stalemate? European Consumer Insolvency Law Reform and the Politics of Household Debt’ (2013) 21(3) *European Review of Private Law* 747-794

<sup>96</sup> See D. Cerini, *Sovraindebitamento e consumer bankruptcy: tra punizione e perdono* (Milan, Giuffrè, 2012)

<sup>97</sup> Art 12-bis, L. 3/2012, as modified by D.L. 179/2012 and L. 221/2012



would seem that the practical relevance of this latter provision on the disproportionate use of credit would be limited if an analogous assessment on credit worthiness had been performed *ex ante* by the financial services provider in compliance with his responsible lending obligations. The two assessments are nonetheless quite different and serve different purposes: the one performed by the prospective creditor aims at determining whether the customer will be able to fulfil her financial obligations, while the assessment performed by a judge only serves to investigate the reasons why the debtor did not fulfil those obligations, with a view to preventing abuses by a bad faith debtor. It may easily occur that after having ‘passed’ the first assessment, as it appears reasonable that she will honour a debt, a debtor might fail the second one because, despite having the financial means to fulfil the obligations, she is unable to pay for some other reason or because, taking a broader view of her whole financial situation, a judge deems the consumer’s use of credit disproportionate. As such, this multiplication of assessments appears to play the legitimate role of avoiding abuses of the system, although it might open the door to arbitrary considerations of what proper economic behaviour should be.

At the same time, it is noteworthy that both assessments are designed to detect debtor bad faith, while creditor bad faith does not attract the same level of attention: it is after all well-known that borrowing-lending obligations are in fact mostly framed as responsible borrowing obligations.<sup>98</sup> This imbalance, with the possibility that it overlooks a creditor’s bad faith, is likely to lead to problems, which was indeed evident in the very first judicial decision applying the new law in Italy.<sup>99</sup> In that case, a creditor appealed against the approval of the debt adjustment plan, claiming that the debtor did not in fact deserve debt discharge as he was aware of his financial difficulties at the time of the conclusion of the contract. Leaving aside the specific facts of the case, it emerges that this mechanism might paradoxically allow for this claim to be made by the same subject who, possibly knowing about the economically unsound situation of the consumer, should have reasonably refused giving credit in the first place. As a result, a bad faith debtor who has concealed his or her deteriorated financial status will not benefit from the law, unlike a bad faith creditor who knew about the debtor’s situation and nonetheless extended the credit. This controversial situation, which opens the door to opportunistic behaviour and a ‘short-circuit’ of the debt relief system<sup>100</sup> which is already attracting legislative attention intended to sanction negligent creditors,<sup>101</sup> derives from the ineffectiveness of *ex ante* rules on responsible lending and their lack of coordination with *ex post*

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<sup>98</sup> T. Wilson, ‘The Responsible Lending Response’, in T. Wilson (ed), *International Responses to Issues of Credit and Over-indebtedness in the Wake of Crisis* (Farnham: Ashgate, 2013) 109-134

<sup>99</sup> Tribunale di Pistoia 27 December 2013 and 28 February 2014 commented by E. Pellecchia, ‘Composizione delle crisi da sovraindebitamento: Il “piano del consumatore” al vaglio della giurisprudenza’ (2014) 1 *Diritto Civile Contemporaneo*

<sup>100</sup> E. Pellecchia, ‘Composizione delle crisi da sovraindebitamento: Il “piano del consumatore” al vaglio della giurisprudenza’ (2014) 1 *Diritto Civile Contemporaneo*

<sup>101</sup> Legge 19 ottobre 2017, n. 155 Delega al Governo per la riforma delle discipline della crisi di impresa e dell’insolvenza, art. 9, l)

measures. Those latter measures become more stringent when *ex ante* mechanisms are not sufficiently developed. This is in fact paradoxical, since it is exactly the consumer who has not been screened in the first place who is more likely to end up over-indebted and therefore more in need of a debt relief.

While a lack of coordination between different doctrines might lead to controversial outcomes, it should be incidentally noticed that this is not only due to a technically flawed design, but more fundamentally to the persistence of a view of over-indebtedness as the main responsibility of the debtor rather than that of the creditor, despite the recurring suggestion in international literature that regulation should place a heavier burden on the credit industry sanctioning operators who take advantage of weak consumers.<sup>102</sup> Again, the lesson is that over-indebtedness should be viewed as inherent to the credit economy, rather than as isolated and morally repugnant individual behaviour.

## Conclusion

While rising levels of consumer and household indebtedness have become a concern in most countries during the debt crisis, the European regulatory infrastructure became characterised by a complicated balance between the hardly reconcilable goals of promoting indebtedness on the one hand and of counteracting over-indebtedness on the other hand. As policies of financial inclusion attempt to make financial services more accessible to consumers, the likelihood that the latter will face debt problems has also augmented, especially if access to those services is not counterbalanced by appropriate measures meant to ensure protection. Against this background, over-indebtedness plainly emerges as an offshoot of the credit economy, and requires appropriate forms of regulation. Nevertheless, the difficulty in drawing a clear-cut distinction between the two phenomena of indebtedness and over-indebtedness, together with the relative indifference of traditional private law to the problems of a debtor and to the ‘causes’ leading to the impossibility of repaying a debt, poses several problems hampering the development of one coherent strategy to address the phenomenon. If there cannot be one single and overall doctrine to solve the problem, a plurality of mechanisms to cope with the negative repercussions of the promoted indebtedness appears on the contrary required. Different strategies can be deployed, ranging from financial education, to the employment of contract law doctrines to invalidate excessively onerous contracts, to consumer insolvency regimes. This paper has evidenced that those instruments are not functionally equivalent options, but are rather complementary: considering the multifaceted nature of the phenomenon of over-indebtedness, a combination of both preventive and curative, as well as contractual and non-contractual measures is necessary. As legal systems lack one of those instruments, the others will have to play a more significant role in practice, occasionally even stretching the borders of juridical notions. A quick look at legal evolution in fact reveals that the law of debt has always relied on a combination of public and private instruments to deal with debt

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<sup>102</sup> J. Ziegel, ‘Facts on the Ground and Reconciliation of Divergent Consumer Insolvency Philosophies’ (2006) 72 *Theoretical Inquiries in Law* 306-307

problems of individuals, as the strict approach of contract law to monetary obligations was attenuated by exceptional moratoria, discharge mechanisms, or even the welfare state.

This has two implications: in the first place, and with respect to comparative research, focusing only on the way in which a particular remedy works in different jurisdictions might offer a partial and misleading picture of the way in which over-indebtedness is dealt with in that legal and social order at large, if one does not also consider the significance of other measures. For instance, and in the sole perspective of debtor protection, a lax supervisory system might be slightly less inappropriate if on the other hand indebted consumers have easier access to debt discharge. Even more fundamentally, although not the specific focus of this contribution, the lack of welfare-state mechanisms to alleviate social vulnerability is likely to increase the risk of over-indebtedness, particularly given the labour market is increasing characterised by processes of workforce casualisation, which make individuals more vulnerable to unexpected economic difficulties.

Secondly, the fact that there is an interrelation between *ex ante* and *ex post* measures should not lead us to downplay the risk that some measures are employed for achieving objectives that would be more efficiently or more correctly achieved through different means. Associated with financial regulation, new *ex-ante* mechanisms have been implemented in particular with regard to banking and financial contracts, but over-indebtedness rooted in other contractual relations regrettably appears to be less regulated by appropriate preventive rules. At the same time, although *ex-post* instruments can relieve *ex-ante* mechanisms from part of the pressure of counteracting over-indebtedness, they also tend to be more bothersome for both creditors and debtors, and could therefore be better employed as a last resort, as also suggested by the Council of Europe.

The choice for preventive, curative, contractual or non-contractual strategies to tackle the problem of over-indebtedness is not value-free and there is in principle no best approach, as long as a well-functioning interplay between curative and preventive measures is ensured.