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Financial Stability is a Volume Business: A Comment on the Legal Infrastructure of Ex Post Consumer Debtor Protections


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**FINANCIAL STABILITY IS A VOLUME BUSINESS:
A COMMENT ON *THE LEGAL INFRASTRUCTURE
OF EX POST CONSUMER DEBTOR PROTECTIONS***

*Anna Gelpern**

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INTRODUCTION

Professor Melissa B. Jacoby’s essay¹ pays homage to Stewart Macaulay’s classic study of the Magnuson-Moss Warranty Act, a U.S. federal consumer protection law that, according to Macaulay, was virtually unknown to the lawyers whose clients needed it the most.² The moral of Macaulay’s study is that even good consumer protection laws on the books often fail to deliver in action for complex cultural, institutional, and economic reasons.³ Yet reducing Professor Jacoby’s essay to this very important moral undersells its contribution. A fragmented infrastructure for legal service delivery of the sort she describes does not merely fail consumers more often than it should, but can frustrate economic policy, delay crisis response, and undermine financial stability. By implication, rationalizing legal service provision is key to the success of both crisis management and financial reform.

In this Comment, I first situate household debt in the context of financial stability. Second, I highlight elements of Professor Jacoby’s argument most relevant to financial stability concerns. Third, I sketch out several po-

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1. Melissa B. Jacoby, *The Legal Infrastructure of Ex Post Consumer Debtor Protections*, 38 *FORDHAM URB. L.J.* 751 (2011).

2. *See id.* at 761.

3. *See id.*

tential implications of her contribution for crisis response and financial regulation.

I. HOUSEHOLD DEBT AND FINANCIAL STABILITY

By the end of the twentieth century, ordinary people joined the global capital markets in force. The rapid expansion of consumer finance in recent decades is variously attributed to government policy and the growth of financial and information technology. For example, as governments loosened restrictions on cross-border capital movements, Argentine, Icelandic, and Hungarian households borrowed in foreign currency, notably to finance housing with long-term loans, unavailable or prohibitively expensive in local currency. An Indian firm launched a public offering to fund tiny loans to the poor.⁴ Securitization techniques transformed small, idiosyncratic, and illiquid consumer and housing loans made in the United States into standardized bundles packaged and repackaged to meet the risk and liquidity demands of diverse constituents around the globe. Policy and market forces thus combined to produce a period of apparent global capital abundance, albeit one punctuated by financial crises that implicated households directly.

The transformation of retail debt into wholesale capital flows had important benefits in the form of economic growth and financial inclusion: more and cheaper money to the masses. Therein too lay the costs. More, cheaper money to the masses produced credit bubbles, which burst and left behind insolvent institutions and over-indebted people in Argentina, Iceland, Hungary, India, and the United States alike. Financial technology made it possible to multiply and spread consumer debt throughout the financial system,⁵ with pockets of risk concentration in critical places. If they are sufficiently numerous, small consumer debts that populate key financial institutions but exceed debtors' capacity to pay can bring down the economy as a whole. First, they can bankrupt creditors and disrupt intermediation. Second, they may depress consumer spending and with it aggregate consumption, growth, and employment. Third, they may neglect or rush to sell assets, such as homes, contributing to depressed asset prices.⁶ Other costs

4. Bruce Einhorn, *A Microfinance IPO in India*, *BUS. WK.*, May 6, 2010, http://www.businessweek.com/magazine/content/10_20/b4178016201790.htm.

5. Adam J. Levitin & Susan M. Wachter, *Explaining the Housing Bubble* (Inst. for Law & Econ., Univ. of Pa. Law Sch., Res. Paper No. 10-15, 2010), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1669401.

6. See LUC LAEVEN & THOMAS LARYEA, INT'L MONETARY FUND, *PRINCIPLES OF HOUSEHOLD DEBT RESTRUCTURING* (2009); Erik F. Gerding, *The Subprime Crisis and the Link Between Consumer Financial Protection and Systematic Risk*, 4 *FIU L. REV.* 435 (2009); see also Anna Gelpern & Adam Levitin, *Rewriting Frankenstein Contracts: Wor-*

of turning consumer debt into capital markets debt are more subtle: for example, securitization transplants a “contractual bankruptcy”⁷ model designed for firms into the world of consumer finance for which they are ill-suited.⁸

It follows that stabilizing a complex modern financial system in crisis and creating a stable system going forward require capacity to manage household debt on a large scale. Managing household debt with a view to financial stability is a task somewhat different from consumer protection for its own sake, or as a way to address social problems. The size of aggregate household debt and the elaborate ways in which household finances now link to critical economic and financial functions, make an ordinary person’s money troubles a matter of system-wide, or macroprudential,⁹ concern.

From the perspective of the system as a whole, in crisis, the principal goal is to reduce the aggregate level of consumer debt quickly, but mindful of the costs to creditors and fiscal authorities, as well as debtor and creditor moral hazard. Outside the crisis context, the goal is to understand the way in which consumer debts can create large-scale social and financial vulnerabilities, and to design laws and institutions to address such vulnerabilities. For example, understanding behavioral biases and collective action problems in predatory lending,¹⁰ the effect of asset securitization on contract modification,¹¹ or the distinct path of failure in microfinance,¹² can in-

kout Prohibitions in Residential Mortgage-Backed Securities, 82 S. CAL. L. REV. 1075, 1127 (2009).

7. See Gelpern & Levitin, *supra* note 6, at 1123.

8. See *id.* at 1124.

9. See generally Gabriele Galati & Richhild Moessner, *Macroprudential Policy—A Literature Review* (Bank for Int’l Settlements, Working Paper No. 337, 2011), available at <http://www.bis.org/publ/work337.pdf>.

10. See Gerding, *supra* note 6.

11. See Sumit Agarwal et al., *The Role of Securitization in Mortgage Renegotiation* (Fed. Reserve Bank of Chi., Working Paper No. 2011-02, 2011), available at http://www.chicagofed.org/digital_assets/publications/working_papers/2011/wp2011_02.pdf; cf. Manuel Adelino et al., *Why Don’t Lenders Renegotiate More Home Mortgages? The Effect of Securitization* (Fed. Reserve Bank of Atlanta, Working Paper No. 2009-17a, 2010), available at <http://www.frbatlanta.org/documents/pubs/wp/wp0917a.pdf>.

12. See Daniel Rozas, *Throwing in the Towel: Lessons from MFI Liquidations*, MICRO-FINANCE FOCUS (2009), <http://www.microfinancefocus.com/news/wp-content/uploads/2009/09/Throwing-in-the-Towel.pdf>; Soutik Biswas, *India’s Micro-Finance Suicide Epidemic*, BBC NEWS (Dec. 16, 2010, 5:12 PM), <http://www.bbc.co.uk/news/world-south-asia-11997571>; Yoolim Lee & George Smith Alexander, *India’s Microfinance Clampdown May Trigger Failures*, *World Bank Aide Says*, BLOOMBERG (Nov. 22, 2010), <http://www.bloomberg.com/news/2010-11-21/india-s-smaller-micro-lenders-likely-to-fail-srinivasan-says.html>.

form consumer protection efforts and policy design for system-wide stability.

Government intervention, including sticks and carrots to promote consumer debt relief, is justified where large-scale deleveraging must happen quickly, where institutional capacity is limited relative to the debt problem, where crisis conditions or other information problems impede market valuation, and where collective action problems or rigid contracts discourage renegotiation. Conditions for intervention may arise in a full-blown crisis, but also in more limited circumstances, where it becomes important to stop the spread of debt distress before it infects the system. The manner of government involvement can range from facilitating case-by-case adjudication (e.g., more judges, tighter deadlines) to blanket contract modification, with options in between including conditional subsidies, streamlined administrative procedures, and new substantive rights. The choice depends on the reasons for intervention, as well as the government's own fiscal and institutional capacity. This is where the infrastructure for delivering legal services becomes crucial.

II. HOUSEHOLD DEBT AND LEGAL SERVICES

In 1933, a Minnesota couple sought to save their fourteen-room home and rental property from foreclosure.¹³ They applied to a judge for relief, citing the state foreclosure moratorium of the sort widespread at the time, which deferred the creditor's enforcement for up to two years, provided the creditor received "reasonable rental value" in the interim.¹⁴ The measure famously and controversially survived challenge under the Contracts Clause of the U.S. Constitution as a time-limited exercise of existing state police power justified by extreme crisis circumstances.¹⁵ At the same time, the federal authorities enacted measures to strip gold indexation from public and private contracts and revamp the regime for farm bankruptcies, as well as establish institutions to buy, guarantee, and restructure distressed mortgages, such as the Home Owners Loan Corporation. None of these measures proved to be the silver bullet for broad-based household debt reduction, though some of the more radical measures gave debtors liquidity relief. The crisis that began in 2007 brought about more timid incarnations of Depression-era measures, which have so far relied on voluntary action by debtors and creditors, and limited federal subsidies, with very modest

13. See *Home Bldg. & Loan Ass'n v. Blaisdell*, 290 U.S. 398 (1934).

14. See *id.* at 415-16.

15. See *id.*

results for debt or liquidity relief.¹⁶ More durable structural changes, such as restoring borrowers' capacity to modify home mortgages in bankruptcy, received new impetus with the crisis, although these have had no legislative success to date.

There is no shortage of explanations for the failure of U.S. household de-leveraging efforts to date, ranging from financial structure and servicer incapacity to accounting rules. Addressing the criticisms and enacting mortgage modification in bankruptcy would no doubt improve the statistics. Professor Jacoby's essay points to a new set of under-appreciated, important, and deeply discomfiting reasons why even the most sensible fixes to substantive law might not produce debt relief on a scale necessary either to resolve the crisis, or to establish a sustainable infrastructure for household debt management going forward.¹⁷ Her insights are important because they potentially illuminate the difference between success and failure for substantive law reform; they are discomfiting because the problems she identifies have no easy answers.

Professor Jacoby paints a picture of a highly fragmented system, where state and federal authorities offer distinct and functionally overlapping legal regimes to help debtors protect their assets (most importantly, their homes) in financial distress.¹⁸ A federal monopoly on coercive contract modification in bankruptcy gives borrowers powerful leverage against creditors in some circumstances, but at a high cost. Some debtors may be able to keep their property and achieve other important objectives for less with *ex post* state protections.¹⁹ State protections, in turn, come by way of both uniform and non-uniform laws.²⁰ Crises add an overlay of state and federal emergency measures.²¹

The choice of protective strategies in multiple, overlapping, and highly complex legal systems can seem close to accidental in this telling. Put differently, today's Blaisdells may have no understanding and no capacity to choose the way in which they shield what matters to them. Even where the distressed debtors have the wherewithal to seek legal help, and to follow

16. See generally *Making Home Affordable Program: Servicer Performance Report Through January 2011*, MAKING HOME AFFORDABLE PROGRAM, available at http://www.treasury.gov/initiatives/financial-stability/results/MHA-Reports/Documents/Jan_2011_MHA_Report_FINAL.PDF; *FHA Secure Refinancing Cancelled*, FHA.COM, http://www.fha.com/fha_article.cfm?id=29 (last visited Mar. 16, 2011); MAKING HOME AFFORDABLE.GOV, <http://www.makinghomeaffordable.gov/pages/default.aspx> (last visited Mar. 9, 2011).

17. Jacoby, *supra* note 1, at 762-63.

18. *Id.* at 756-58.

19. *Id.* at 758-59.

20. *Id.* at 756.

21. *Id.* at 759.

through with any of the available remedy routes, the outcome may depend on the specialization of a nearby lawyer, an accident of geography.²²

This state of affairs is problematic enough as a matter of consumer protection, even allowing for the virtues of legal experimentation and regulatory competition between state and federal authorities, and among states. Distressed debtors are left no means to make critical decisions at a time when they can least afford to be put in such a circumstance. This state of affairs is even more problematic as a matter of economic policy and financial stability: a large-scale deleveraging program that depends on the efforts of stressed and vulnerable individuals within multiple, overlapping, and highly complex expert systems may well be doomed to fail.

III. LEGAL SERVICES AND FINANCIAL STABILITY: WHAT IS TO BE DONE?

One conceptually simple and likely unattainable, fix for the fragmentation of debtor protection “law in action” might be to educate all lawyers dealing with distressed debtors in all debtor protection systems, at least so they know when and how to seek help from other experts. Some mix of professional licensing and private ordering might promote such an outcome, but it seems burdensome and unlikely to come about soon. Another possibility is to institute streamlined administrative procedures to replace the current patchwork of legal systems. This too is a tall order. Such measures, which have been used in some economies by way of crisis response, are highly disruptive to the functioning of the existing legal system, and take a level of administrative capacity that, had it existed in the first place, might have made special procedures unnecessary. Even so, there may be a case for streamlining in some areas, notably the restructuring of housing finance, where both leverage and social costs of failure are high.

Professor Jacoby’s essay hints at another possibility: greater use of institutional intermediaries, especially non-lawyers, to help debtors choose the appropriate mix of legal and financial tools to resolve distress.²³ The ongoing housing finance crisis has helped start a cadre of such intermediaries among and beyond legal professionals; however, experience to date shows that an unregulated market for intermediary services is at high risk for fraud and abuse, exacerbated by distressed debtors’ heightened vulnerability to exploitation. Reputable nonprofits offer a variation on the intermediary theme; however, their operations are unlikely to be scalable to the point of addressing financial stability. Moreover, nonprofit regulation does

22. *See id.* at 760-62.

23. *See id.* at 764.

not lend itself easily to regulation for the quality of legal and financial services provided or referred.

In sum, fragmentation in the institutional structure for providing legal services to distressed debtors can be an impediment not just to the goals of consumer protection, but also to the financial stability objective when it requires household debt restructuring. An important implication of Professor Jacoby's argument is that such fragmentation can distort *ex ante* lending and borrowing incentives, and can frustrate timely management of consumer debt distress before a full-blown crisis has broken out.²⁴ In this way, the legal infrastructure within which debtor-creditor law is practiced may both contribute to the build-up of household debt, and impede its resolution.

CONCLUSION

Consumers are a volume business when times are good, as well as when times are bad. Finding an institutional approach to manage the volume without sacrificing equity, while preserving and enhancing incentives for sound lending and borrowing, is an urgent task. Professor Jacoby's essay makes an important contribution to mapping out such an approach.

24. It does not seem clear which way the distortion would run.

