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COMMENTARIES

# Predatory Formations: Post-Financial Crisis Lessons for the US and Europe

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## 1. Introduction

Saskia Sassen, in the Montesquieu lecture that took place at Tilburg University on 4 April 2019, discussed a range of movements in society that occur somewhat under the radar but that have a significant impact on the division of wealth and power, globally and locally. Investors from Asia and the Middle East are buying property in the world's major cities, such as London, New York, Toronto, and Amsterdam. The buildings acquired by these investors are often not lived in, the ramification of which is that many inner-city residential blocks remain unoccupied, whilst local residents are having a hard time finding suitable and affordable accommodation. A second example concerned the emergence of 'dark pools' of financing, controlled by private actors operating in the shadow of the official banking system. Third, Sassen reflected on the causes of the sub-prime mortgage crisis of 2007 and its aftermath. In the US as well as in Europe, many consumers lost their homes when the financial system collapsed.

The connecting thread between these examples is Sassen's extraction logic. In other words, the finding that vulnerable groups in society are exploited for the gain of other economically or politically powerful actors. Regarding the financial sector, in the aftermath of the financial crisis, she wrote: "[a]t its most brutal and innovative, I argue that finance is an extractive sector: once it has extracted what there is to extract, it moves on, leaving behind destruction. ... In contrast to finance, traditional banking gains when its borrowers grow, do well and keep borrowing. At its best, traditional banking enables others, while finance, at its best, destroys others to enable itself."[1] That description of the financial sector captures, in a nutshell, the underlying dynamics that led to the development of innovative securitisation structures in the financial sector, built upon the sale of mortgage loans by banks, which were thought to provide a steady and safe return on investments. The foundations of these structures however became shaky when the system turned to selling sub-prime mortgages to vulnerable borrowers.[2]

In this short contribution, I will reflect upon the question of how Sassen's observations on extractive forces in the US financial sector compare to Europe. Although the dynamics between banks and consumer-clients appear to be influenced by a similar logic, the expressions of that logic in Europe vary. Consumers are in some ways better protected against predatory lending practices due to regulation, either at the level of the European Union or at the level of a national legal system. For that reason, the mortgage crisis that hit Europe in 2008 played out differently here than it did in the US, and the regulatory response has focused on other risk factors. Notably, differences exist also because consumer mortgage markets in the EU are still primarily national affairs. Although the EU introduced harmonising legislation for consumer mortgage agreements in 2016,[3] that legislation only touches upon some aspects of mortgage markets. The economic context within which banks and consumers operate, and which influences the stability of the financial market and of the housing market, differs from one EU member state to another. I will discuss some particular characteristics of northern European member states (the United Kingdom and the Netherlands), of southern

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1 S Sassen, "Predatory Formations Dressed in Wall Street Suits and Algorithmic Math" (2017) 22 Science, Technology & Society 1, 4.

2 For a description of the rise of lending structures in the US and their demise, see e.g. D Immergluck, *Foreclosed. High-Risk Lending, Deregulation, and the Undermining of America's Mortgage Market* (Cornell University Press 2009).

3 Directive 2014/17/EU on credit agreements for consumers relating to residential immovable property [2014] OJ L60/34.

Europe (Spain), and of Central and Eastern Europe (Hungary). By way of conclusion, I will reflect upon the position of the EU as a guardian of consumer protection in European financial markets.

## 2. Northern Europe: the UK and the Netherlands

While northern European countries were affected by the financial crisis of 2008 and the subsequent downturn of the economy, they seem to have had relatively low numbers of mortgage defaults.[4] That is interesting as many of these countries have a high ratio of household debt to gross disposable income, which is often seen as a risk factor that can contribute to mortgage defaults. The UK has a ratio of approx. 149% whilst the Netherlands measured 243% in 2017.[5] Why did these countries not experience the mortgage foreclosures that were seen in the US or the massive amounts of mortgage defaults seen in southern Europe?

One explanation for the difference is that mortgage markets had already been subject to relatively strict regulation for a longer time prior to the financial crisis. This was the case in the Netherlands, Germany, the Scandinavian countries, and to some extent in the UK.[6] Besides regulation, vulnerabilities of households could be kept in check by other economic factors, such as tax deduction schemes, social benefits, or low interest rates.[7]

For the Netherlands, the main challenge to the mortgage market in the wake of the financial crisis was that many mortgage loans were 'under water', meaning that with the drop in housing prices the value of the loan became higher than the value of the underlying property. Although this was seen as a risk to the financial system, and continues to be so, the regulatory framework appears to work sufficiently well in the protection of borrowers against mortgage defaults. Prospective borrowers in the Netherlands, for example, are required to undergo a creditworthiness assessment by a credit provider in order to become eligible for a mortgage loan. The general provision laid down in Article 4:34 of the Dutch Financial Supervision Act (*Wet op het financieel toezicht*, *Wft*) stipulates that the credit provider has to obtain information on the financial position of the consumer and, on the basis of this information, has to assess whether concluding the credit contract would be justified with a view to overextension of credit to the consumer. The specific requirements that the statutory provision entails have been elaborated in secondary legislation, in particular in Articles 113–115 *Besluit Gedragstoezicht ondernemingen Wft* (*BGfo*), and through self-regulation in the code of conduct for mortgage credit providers (*Gedragscode Hypothecaire Financiering*, *GHF*). The framework for assessment is based on two elements: the income of the borrower in comparison to the requested amount of the loan (the LTI ratio), and the market value of the residence in comparison to the loan (the LTV ratio). Although the LTV ratio could be quite high prior to the financial crisis,[8] the regulatory framework nonetheless provided other mechanisms to protect borrowers from mortgage defaults. Some specific characteristics of the Dutch mortgage market include a tax deduction for interest on mortgage loans (*hypotheekrenteaftrek*), a government guarantee scheme for low-income borrowers (*Nationale Hypotheek Garantie*), the social benefits system, the low unemployment rate, a good debt ethic, the relatively modest use of variable interests, and the stable housing market.[9]

The UK, by comparison, was relatively lax with regard to the assessment of the affordability of credit prior to the financial crisis of 2008. On paper, codes of conduct developed by mortgage credit providers required an assessment of LTI ratios before a credit agreement could be concluded. In practice, however, approx. 50% of mortgage loans was given out without verification of the borrower's income.[10] Nonetheless, defaults on mortgage remained relatively low. This has been attributed to low interest rates and lender forbearance. Further, risks are mitigated in part due to the LTV ratio in the UK often being low, in many cases below 90% and often even below 75%.[11] The 2014 Mortgage Market Review, following the financial crisis, has

[4] In the Netherlands, the number was around 100,000, which is low in comparison to the entire number of existing mortgage loans in the country. See De Nederlandsche Bank (DNB), *Overview of Financial Stability* (Spring 2014), pp 21 ff, <https://www.dnb.nl/en/binaries/OFSuk_tcm47-306230.pdf> (last visited 15 May 2019).

[5] OECD (n.d.), <http://stats.oecd.org/Index.aspx?DataSetCode=FIN_IND_FBS#> (last visited 15 May 2019).

[6] Bank of England, *Financial Stability Report* (2014) 57–58, 63.

[7] For a more comprehensive discussion, see V Mak, "What is Responsible Lending? The EU Consumer Mortgage Credit Directive in the UK and in the Netherlands" (2015) 38 Journal of Consumer Policy 411.

[8] The LTV ratio has been lowered from 106% in 2013 to 100% in 2018 on the basis of the Temporary rules on mortgage credit (*Tijdelijke regeling hypothecair krediet*). See Netherlands Government Gazette 2012, no 26433. For amendments to these rules as of 1/1/2014, see Parliamentary Papers II 2013/14, 32847, no 98.

[9] M Kerste cs, *Publieke belangen en hypotheekregulering* (SEO Economisch Onderzoek 2011), p 28.

[10] Financial Services Authority (FSA), *PS12/16 Mortgage Market Review* (London 2012).

[11] Bank of England (n 6), p 24.



introduced an elaborate set of rules and guidelines that aims to keep stricter control of affordability, focusing in particular on LTI and LTV requirements.

Therefore, whereas risk factors remain in the Dutch and UK mortgage markets, they appear to be manageable through regulation, monitoring, and enforcement. One other aspect is important for the comparison with the US. Borrowers in Europe cannot 'walk away' from a mortgage loan upon foreclosure and leave the keys to the house with the bank, as borrowers in the US can in some States,[12] and did in large numbers when they defaulted on sub-prime mortgages. Loans are payable in full to the bank, and if a borrower cannot pay, they either negotiate a payment scheme or, in the worst case, face personal bankruptcy.

## 3. Southern Europe: Spain

The situation in southern Europe has been markedly different from that in the north. Taking Spain as an example, the country suffered high levels of unemployment after the financial crisis, which in turn led to numerous cases of mortgage default. Under Spanish law, banks had strong rights to evict borrowers and reclaim their houses, seeking repayment of the loan through sale of the property. In many cases, contractual terms in the mortgage agreement meant that the bank could start this procedure after one mortgage instalment had remained unpaid. The social consequences of the crisis hit borrowers in the same way as the sub-prime mortgage crisis in the US: they became homeless.

The response came from an unexpected corner. While the Spanish legislator remained inactive in the face of increasing numbers of evictions, and the Supreme Court sided with the banks in the enforcement of legislation, a first instance judge in Barcelona sought an alternative route to protect vulnerable borrowers against eviction. José Maria Fernández Seijo referred a preliminary question to the Court of Justice of the EU (CJEU), seeking to stall eviction proceedings in cases where the borrower challenged unfair terms in the mortgage agreement with the bank. Spanish legislation at that time did not allow for that possibility. The CJEU in its now famous judgment in *Aziz* held that the Spanish legislation constituted a limitation of consumer protection, since it involved a clear impediment to the consumer's exercise of rights of action or judicial remedies of such a kind as to guarantee the effective protection of his rights.[13] In response, the Spanish legislator has amended the relevant legislation.[14] Litigation on unfair terms in consumer contracts has continued to combat banks' lending practices in Spain.[15]

## 4. Central and Eastern Europe: Hungary

Consumers in Central and Eastern European countries also suffered the consequences of innovative financing. In these countries, for example in Hungary, Romania and the Czech Republic, mortgages were unknown until relatively recently, when a shift occurred from socialism to market capitalism. Since then, mortgage loans were marketed on a large scale without significant creditworthiness assessments.[16] In Hungary, most problems arose from mortgage agreements involving foreign currency loans. The amount of Swiss Franc denominated loans went from almost zero in 2004 to 90% of the mortgage portfolio in 2008.[17] While these loans were profitable to the banks that supplied the credit, they were highly risky for consumers. Most loan agreements stipulated a variable interest rate and gave broad powers to the creditor unilaterally to change the contract. This meant that the exchange rate risk was transferred to consumers. Since the banks' practice had been to market these loans to consumers without a thorough creditworthiness check, and often giving out loans for amounts exceeding a 100% LTV ratio, when that risk materialized it had devastating consequences. The number of defaults on mortgages rose steeply after the financial crisis of 2008. To help debtors and to stabilize the financial system, government rescue programmes and new legislation were introduced.

[12] Although it has been argued that in many US states, like in Europe, residential mortgages are recourse loans; see AC Ghent and M Kudlyak, "Recourse and Residential Mortgage Default: Evidence from US States" (2011) 24 The Review of Financial Studies 3139.

[13] Case C-415/11 *Mohamed Aziz v Caixa d'Estalvis de Catalunya, Tarragona i Manresa (Catalunyacaixa)* [2014] ECLI:EU:C:2013:164, para 31.

[14] Although the initial legislation, as it turned out, did still not comply with the effectiveness principle of EU law; Case C-169/14 *Juan Carlos Sánchez Morcillo and María del Carmen Abril García v Banco Bilbao Vizcaya Argentaria SA (Sánchez Morcillo I)* [2014] ECLI:EU:C:2014:2099.

[15] See e.g. C Mak, "*Gutierrez Naranjo*: On Limits in Law and Limits of Law" (2018) 43 European Law Review 447.

[16] R Simon, "Transposition of the Mortgage Credit Directive into Hungarian and Czech Law – The Problem of Credit Intermediaries" (2017) 6 Journal of European Consumer and Market Law 106, 107.

[17] A Fejős, "Mortgage Credit in Hungary" (2017) 6 Journal of European Consumer and Market Law 139.

Some loans were converted into the local currency, and of the most vulnerable, the state took over the debt obligation.[18] Similar problems with foreign currency mortgages were encountered in Romania.[19]

In these legal systems, like in Spain, consumers also sought relief through challenging unfair contract terms in the mortgage agreement. The CJEU's judgment in *Kásler* has been seen as a win on the side of consumers, as it emphasizes that standard terms in the contract concerning the foreign currency exchange rate should be transparent to the 'average consumer'. Moreover, this entails that the consumer could have assessed the potentially significant economic consequences of the term before entering into the contract.[20] If a term is considered to fail the transparency test on these grounds, the national court can assess the term for fairness and set it aside if it considers the term unfair.[21] If the contract cannot exist without the deleted term, there is room to substitute it with a supplementary provision of national law. The precise ramifications of that ruling depend on national contract laws. While *Kásler* can be regarded as a major step towards consumer protection in mortgage loan contracts, it should also be noted that in practice the courts lacked the means to achieve individual justice in cases coming before them after the crisis.[22]

## 5. Concluding Remarks

Comparing the responses to crises in the financial market, it is interesting to observe that European countries have focused on the regulation of mortgage agreements as a mechanism to curb consumer over-indebtedness and to ensure the stability of the financial system. While the regulation of contracts is one route towards more responsible lending,[23] it has also been recognized that private law is not the only vehicle for ensuring consumer protection in financial markets.[24] The economic and regulatory context within which mortgage agreements are embedded is of much greater influence on access to credit, financial stability and protection against over-indebtedness.

In all of these respects, the EU and its member states have, more than the US, the ability to protect consumers against extractive practices of banks and other financial institutions.[25] Regulation is politically more accepted and it has increasingly been used as an instrument for governments to ensure the stability of the financial system and responsible lending practices. The EU has been an important instigator of regulation, moreover, introducing transparency requirements for credit rates and a mandatory creditworthiness assessment for consumer mortgage loans,[26] that was new to many member states' laws. While regulation can be criticized for placing a heavy responsibility on consumers, who are expected to make responsible financial decisions primarily on the basis of information provided to them, the maintenance of a creditworthiness assessment can be an effective mechanism for protection of the most vulnerable.

That is not to say that European consumers are safeguarded from all forms of exploitation by financial institutions. Innovative credit and investment products will continue to be developed and they are likely to lead to large-scale financial losses amongst consumer groups every once in a while. Even relatively robust systems, such as the UK and the Netherlands, have had such cases, e.g. in relation to payment protection insurance and complex investment schemes based on credit (*aandelenlease*). From a regulatory perspective, therefore, the awareness that the financial sector is influenced by extractive dynamics between banks and consumers is an important reason to monitor innovative financing schemes closely.

## Competing Interests

The author has no competing interests to declare.

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18 Ibid.

19 B Andresan-Grigoriu and M Moraru, "Country Report Romania" in H-W Micklitz and I Domurath (eds), *Consumer Debt and Social Exclusion in Europe* (Ashgate 2015) 117.

20 Case C-26/13 Árpád *Kásler, Hajnalka Káslerné Rábai v OTP Jelzálogbank Zrt* [2014] ECLI:EU:C:2014:282, para 74.

21 In some systems, non-compliance with the transparency requirement is considered to constitute unfairness, and that conclusion is in line also with the CJEU's judgment in *Amazon*. See Case C-191/15 *Verein für Konsumenteninformation v Amazon EU Sàrl*, ECLI:EU:C:2016:612, para 71. German law already held the view that a breach of the transparency requirement implies unfairness, a position codified in § 307(1) of the German Civil Code. For the Netherlands, see MBM Loos, *Algemene voorwaarden* (Boom juridische uitgevers 2018), para 242.

22 See e.g M Józon, "Country Report Hungary" in H-W Micklitz and I Domurath (eds), *Consumer Debt and Social Exclusion in Europe* (Ashgate 2015) 85, 91.

23 Compare I Domurath, *Consumer Vulnerability and Welfare in Mortgage Contracts* (Hart Publishing 2017), who argues that contract law should adapt to the social function that mortgage contracts have.

24 G Comparato, *The Financialization of the Citizen* (Hart Publishing 2018) ....

25 See also A Fejős, "Social Justice in EU Financial Consumer Law" (2019) 24 Tilburg Law Review 68.

26 Directive 2008/48 on credit agreements for consumers [2008] OJ L133/66; Directive 2014/17 on mortgage credit (n 3).



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