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Addressing the Challenges of Post-pandemic Debt Management in the Consumer and SME Sectors: A Proposal for the Roles of UK Financial Regulators

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Abstract

Regulatory actions for short-term debt-relief during the Covid-19 pandemic are facilitating a significant level of indebtedness. We argue that regulators, in leaving the banking sector to manage small business and consumer debtors in ‘tailored arrangements’, risk allowing financial welfare goals to be unmet. Financial welfare goals are important to the Financial Conduct Authority’s (FCA) consumer protection objective and give substantive meaning to the long-term financial stability objective of the Prudential Regulation Authority (PRA). Although the struggles with debt on the part of small and medium-sized businesses and households are not capable of complete resolution by financial regulators, who are constrained by their statutory mandates, we argue that the PRA and FCA should establish a coordinated supervisory framework of ‘tailored supervision’ for banks’ ‘tailored arrangements’ with their debtors. This proposal allows both regulators to address to an extent the needs of unsophisticated post-pandemic debtors and meet their objectives in a joined-up and holistic manner.

Keywords: bank regulation, prudential regulation, consumer debt, covid-19 pandemic, consumer protection, tailored arrangements.

1. Introduction

The Covid-19 pandemic, which has taken the UK and Europe by storm from early March 2020, is a public health crisis entailing significant financial consequences for households and corporations. The need for social distancing and changes to social interaction have affected

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many economic sectors and workplaces,¹ also impacting household income and welfare.² Financial regulators have responded to the financial pressures resulting from the pandemic, although their actions are only part of the broader mosaic of financial measures introduced by the government.³ Financial regulators' responses predominantly target immediate short-term needs, and relate to access to credit. However, regulators have been reticent to address the long-term hazards that follow from these measures, in relation to corporate and household indebtedness. We provide an overview of the financial regulatory measures intended to help households and corporations.

As this paper focuses on financial regulators' actions during the pandemic, the discussion does not extend to all financial measures taken by UK policymakers during the pandemic. We are chiefly concerned that financial regulators are leaving to lenders to address debt management issues by households and small businesses, and that there is more scope for regulatory scrutiny and action, consistent with regulators' objectives. We argue that the FCA and PRA should engage in joint efforts that would address at least in part the challenges of debt management by consumers and SMEs.

The objectives of the PRA and FCA are both industry-facing and socially-facing. With the establishment of the PRA in 2013 and its dedication to maintaining the safety and soundness of its regulated entities, principally banks, it may be argued that financial regulation objectives, including the preservation of financial stability,⁴ are highly *industry-facing* in that they seek to protect the industry of finance as a proxy for social good.⁵ The *socially-facing* aspect of financial regulation has been confined to protecting consumers,⁶ as one of the FCA's objectives,⁷ but this aspect has become more demanding and expansive with the footprint of financialisation.⁸ In a context where everyone's financial needs, from sovereigns to corporates to households, are mediated by the financial sector, the rise of

¹ All URLs were last accessed on 1 October 2021.

² 'Coronavirus: The world in lockdown in maps and charts' (7 April 2020), <https://www.bbc.co.uk/news/world-52103747>.

³ Chok S., 2020. Covid-19: Impacts on Employment & Household Income (18 March 2020), from <http://beyondresearch.sg/covid-19-impacts-on-employment-household-income/>.

⁴ These include the Coronavirus Business Interruption Loan Scheme (infra n 37), the Coronavirus Business Interruption Loan Scheme (infra n 21), the Bounce Back Loan Scheme (infra n 22), and the Bank of England's Term Funding Scheme (infra n 26). Such measures were complemented by regulatory initiatives by the FCA to provide payment holidays and the PRA to relax prudential regulatory requirements to facilitate bank lending. See Section 2 for a detailed discussion.

⁵ Andenas M., Chiu I.H.Y., 2014. *Foundations and Future of Financial Regulation*, ch. 2. London: Routledge.

⁶ The PRA is also vested with a range of other statutory objectives -specifically, the insurance objective (s 2C FSMA 2000), a secondary competition objective (s 2H(1) FSMA 2000) and a ring-fencing objective (s2 B(3) (c), 2 B (4A) and Part 9B of the FSMA 2000). See on this discussion Georgosouli A., 2013. The FCA-PRA coordination scheme and the challenge of policy coherence. *Capital Markets Law Journal* 8 (1): 64-65.

⁷ Financial Services and Markets Act 2000, s 1B, amended in 2012.

⁸ Ibid. The other two objectives are the market integrity objective and the competition objective.

⁹ Palley T.I., 2013. *Financialization: The Economics of Finance Capital Domination*, ch. 2. London: Palgrave Macmillan.

financial citizenship⁹ provides a changing and dynamic context for financial regulation to be sufficiently socially-facing. This means not only protection from harm, but increasingly engaging with financial welfare outcomes¹⁰ for citizens who have no choice but to rely on private sector dominated financialisation. In this manner, the marked expansion in prudential regulation after the global financial crisis needs increased rebalancing with socially-facing objectives that protect users' welfare in accessing finance. This is important given policymakers' embrace of continued financialisation to meet citizens' needs and to secure their 'financial inclusion'.¹¹

We argue that financial regulators' immediate measures to address the effects of the pandemic reflect an unprecedented exercise of powers in their assumption of socially-facing roles to achieve short-term welfare effects for corporations and households (Section 2). In this manner, regulators have responded to needs for financial welfare, which amount to more than the mere ability to service one's debts, and encompass subjective financial well-being and the avoidance of hardship. It may be argued that such an approach is inconsistent with regulators' mandates or jurisdictions, a challenge that has now been raised against the Federal Reserve Board in the US in the wake of its lending and market support roles to mitigate the adverse economic consequences of the pandemic.¹² However, we see this moment as reflective of the organic development of financial regulators' mandates, as regulators respond to *socially-facing* needs and reckon with potential conflicts with their *industry-facing* objectives. We argue in Sections 3 and 4 that regulators' statutory objectives to protect consumers (the FCA) and maintain financial stability (the PRA) are able to accommodate a sustained socially-facing approach to regulating and supervising post-pandemic debt management. This would provide continuity to the trajectory of their pandemic responses to free up more credit for households and corporations. This article, however, does not preclude the salience of other financial measures to meet post-covid recovery needs, such as public investment, subsidies and tax regimes, or the roles of consumer bankruptcy law and corporate insolvency law in providing mechanisms for debt restructuring, write-offs and business rescue.¹³

⁹ Gray J., Hamilton J., 2006. *Implementing Financial Regulation: Theory and Practice*, ch. 6. London: John Wiley & Sons Inc.

¹⁰ Weinberger M.D., 2019. Scope of Protection: Is There a Ground for a Single Criterion? In: *European Financial Regulation: Levelling the Cross-sectoral Playing Field*, 1st edition, edited by Colaert V., Busch D., and Incalza T., ch. 12. Oxford: Hart Publishing.

¹¹ Discussed in Comparato G., 2020. *The Financialisation of the Citizen*. Oxford: Hart Publishing as a phenomenon in the UK and EU.

¹² Zaring D., 2020. *The Government's Economic Response to the Covid Crisis*, 9, from <https://ssrn.com/abstract=3662049>; Desan C.A., Peer N.O., 2020. *The Constitution and the Fed after the COVID-19 Crisis*, 5-6, from <https://ssrn.com/abstract=3635059>.

¹³ See e.g., Spooner J., 2019. *Bankruptcy: The Case for Relief in an Economy of Debt*, chs 3, 4. Cambridge: Cambridge University Press; Montgomerie J., 2019. *Should We Abolish Household Debts?* London: Polity Press. For a broader critique of financialisation of social life, see Shamir R., 2008. *The Age of Responsibilization: on Market-Embedded Morality*. *Economy & Society* 37 (1): 1.

Section 2 documents the emergency regulatory measures to alleviate immediate financial pressures and argues that these measures reinforce over-indebtedness which can be hazardous for financial welfare and stability in the long term. Section 3 examines the FCA's role in regulating credit for households and businesses and argues for an expansion of the extant regime to meet new post covid debt management needs. Section 4 argues that there is a need to crucially consolidate with the PRA's role, which should not be confined to protecting the banking industry and that there is a need to regard borrowers' financial welfare as necessary to achieve its financial stability objective. Section 5 argues that the PRA and FCA should engage in joint supervisory efforts to centre upon addressing more holistic financial welfare needs as a justifiable interpretation of their objectives. We focus on an extended form of joint supervision that offers practical governance consistent with regulators' objectives. Regulators should also take the opportunity to understand ground-level debt management information in order to feed these insights ultimately into broader policy thinking for debt management by society. Although that is an important topic wider than the scope of this paper, the post-pandemic environment provides an apt context to consider the long-running debt management issues in society and the location of regulators' roles in this mosaic.¹⁴

2. Alleviating the Financial Consequences of the Covid-19 Pandemic – A Double-Edged Sword?

From the first national lockdown in March 2020, the PRA and FCA adopted regulatory measures targeted at the immediate financial welfare of corporations and households. These measures focus on financial welfare as intermediated by the private financial services sector through debt. Although such measures can be seen as providing comfort in the near-term, they do not address the problem that businesses and households are becoming *even more* reliant on debtfare¹⁵ for financial provision, which increases their financial fragility and credit dependence.

Financial regulatory measures to mitigate the financial stress of the pandemic

First, corporations and households were given a period of temporary release from the pressures of debt which have been exacerbated in the weak economic conditions during the pandemic. For households, the FCA, which regulates all forms of commercial consumer credit, introduced rights for mortgage, credit card, motor finance consumers, and unsecured personal borrowers to defer their payment obligations by a maximum of 6 months, by way of

¹⁴ See Howlett M., 2009. Governance modes, policy regimes and operational plans: A multi-level nested model of policy instrument choice and policy design. *Policy Sciences* 42 (1): 82.

¹⁵ See Costantini O., Seccareccia M., 2020. Income Distribution, Household Debt and Growth in Modern Financialized Economies. *Journal of Economic Issues* 54 (2): 444; Soederberg S., 2014. *Debtfare States and the Poverty Industry*, chs 2-3. London: Routledge; Soederberg S., 2013. The US Debtfare State and the Credit Card Industry: Forging Spaces of Dispossession. *Antipode* 45 (2): 495.

a request made between 31 March 2020 and 31 January 2021, to their respective lenders. Lenders are not to conduct diligence investigations into the affordability of such requests and should grant them as a matter of course.¹⁶ Higher risk short-term credit borrowers have also been granted deferred payment.¹⁷ Payment holidays provide temporary relief for borrowers whose cash flow may have been subject to unexpected disruption due to economic lockdowns. The limited deferral period also arguably balances considerations of welfare and expectations on the part of lenders. However, although responsive, across-the-board facilitation of payment holidays is not an unequivocal good for borrowers. Borrowers merely defer debt while prospective economic circumstances remain uncertain. The pressures of debt being a rigid and enforceable contractual obligation remain in full force, albeit slightly deferred, while interest continues accruing during the deferral period.

As the FCA does not have a regulatory mandate for business lending, an Act was passed to give temporary debt relief for business borrowers.¹⁸ This fast-tracked piece of legislation allows companies to apply for a moratorium, with the support of an insolvency practitioner to verify that rescue for the company is possible.¹⁹ A successful application for moratorium permits the company to enjoy relief from its debt obligations, except for specified obligations such as rent and employees' wages.²⁰ Again, temporary debt relief measures are not the same as permanent reprieve. The only reprieve to debtors is that deferred payments are not treated as in default and do not attract penalty charges.

Next, policymakers recognise that during the economic turbulence caused by lockdowns, corporate revenues can become volatile and uncertain. Many corporations need access to increased finance to keep them afloat in relation to expenses, losses and shoring up capital for the future. Private sector lenders may lack incentives to expand lending in these uncertain times. The UK government has therefore implemented fiscal support for corporate borrowing. This is, however, not the same as public-sector provision. The UK government

¹⁶ FCA, 2020. Mortgages and coronavirus: information for consumers, from <https://www.fca.org.uk/consumers/mortgages-coronavirus-consumers> (updated on 19 June 2020); Coronavirus: information for consumers on personal loans, credit cards, overdrafts, motor finance and other forms of credit (3 April 2020), from <https://www.fca.org.uk/consumers/coronavirus-information-personal-loans-credit-cards-overdrafts>; FCA confirms further support for consumer credit customers (1 July 2020), from <https://www.fca.org.uk/news/press-releases/fca-confirms-further-support-consumer-credit-customers>. Since the second lockdown, the FCA has confirmed support for borrowers who have not already deferred payments to be able to make a request, 'FCA announces further proposals to support mortgage borrowers impacted by coronavirus' (2 November 2020), from <https://www.fca.org.uk/news/press-releases/fca-announces-further-proposals-support-mortgage-borrowers-impacted-coronavirus>; FCA announces proposals for further support to consumer credit borrowers impacted by coronavirus (4 November 2020), from <https://www.fca.org.uk/news/press-releases/fca-announces-proposals-further-support-consumer-credit-borrowers-impacted-coronavirus>.

¹⁷ FCA, 2020. High-cost short-term credit and coronavirus: temporary guidance for firms (updated 3 July 2020), from <https://www.fca.org.uk/publications/guidance-consultations/high-cost-short-term-credit-coronavirus-updated-temporary-guidance-firms>.

¹⁸ Corporate Insolvency and Governance Act 2020.

¹⁹ Sections 3, 6, 7, *ibid*.

²⁰ Sections 9-10, 18, 20, 21, *ibid*.

provides fiscal support for two loan schemes. UK businesses with turnover of less than £45mn can benefit from the Coronavirus Business Interruption Loan Scheme which enables accredited lenders to provide loans and overdraft facilities of up to £5mn, guaranteed at 80% by the government, to be repaid over up to six years.²¹ UK small and medium-sized businesses can access the Bounce Back Loan Scheme that provides loan facilities of up to £50,000, guaranteed at 100% by the government to be repaid over up to six years with no payments in the first twelve months.²² These Loan Schemes are administered by private sector lenders who are expected to assess whether eligible businesses are fundamentally healthy, and need finance for the purposes of tiding over short to medium-term revenue loss caused by the lockdown. Government-backed borrowing is assessed and granted on commercial terms, although there are certain minimum safeguards in terms of capped interest rate, an interest-free repayment period and term of loan.²³ On the one hand, private sector due diligence capabilities are called upon to ensure the proper underwriting of loans. This also avoids potential sub-optimality such as nepotism if the government were to engage with loan provision directly.²⁴ However, the government back-stop creates incentives for moral hazard on the part of lenders who would be able to enjoy the private gains of revenues while socialising credit risk losses. Corporations have accessed such lending relatively efficiently during this time,²⁵ but it is uncertain if lenders and borrowers are giving enough thought to the longer-term sustainability of debt burdens. Further, the Bank of England (BoE) provides a Term Funding Scheme (TFSME) which serves as a source of finance for maintaining adequate levels of credit to businesses and households during the pandemic,²⁶ therefore supporting private sector lending as such. The Scheme allows banks and building societies to provide *ad hoc* lending measures to support small and medium-sized enterprises (SMEs) and facilitate

²¹ Department for Business, Energy and Industrial Strategy, 2020. Coronavirus Business Interruption Loan (CBIL) Scheme (23 March 2020), from <https://www.gov.uk/guidance/apply-for-the-coronavirus-business-interruption-loan-scheme>.

²² BEIS, 2020. Apply for a coronavirus Bounce Back Loan (27 April 2020), from <https://www.gov.uk/guidance/apply-for-a-coronavirus-bounce-back-loan>.

²³ See <https://www.british-business-bank.co.uk/ourpartners/coronavirus-business-interruption-loan-schemes/bounce-back-loans/faqs-for-small-businesses/#f7>.

²⁴ Turner A., 2016. *Between Debt and the Devil*, ch. 8. Princeton: Princeton University Press.

²⁵ Over £42bn were lent to over 1.3 million small businesses in the UK and over £4bn disbursed to larger businesses under the CBIL Scheme, benefiting over 1,000 medium sized companies, <https://www.gov.uk/government/collections/hm-treasury-coronavirus-covid-19-business-loan-scheme-statistics>.

²⁶ See <https://www.bankofengland.co.uk/markets/market-notice/2020/term-funding-scheme-market-notice-mar-2020>.

loans at friendly interest rates.²⁷ In parallel, the PRA has suspended the fixed rate lending limits to allow Building Societies to lend more.²⁸

In order to facilitate the deferment of existing debt repayments without triggering treatment as default by lenders, as well as to facilitate increased loan underwriting, the PRA has introduced an extraordinary raft of suspensions of existing regulations. These were originally designed to instil conservatism and prudence in lending after the 2007-09 global financial crisis.²⁹ One way to understand such regulatory suspensions is that the micro-prudential regulations governing banks are inherently flexible.³⁰ Micro-prudential regulations, such as capital buffers for banks to maintain capital against possible loan losses, the leverage ratio that prevents excessive lending in proportion to bank capital and the liquidity ratio which compels banks to maintain an amount of liquid assets in order to meet near-term expenses, are all numerically calibrated.³¹ Such numerical calibrations are not an exact science, and can therefore be remodulated depending on the wider economic circumstances affecting demand for lending. However, a more radical way of conceptualising these measures is that, in these extraordinary times, financial regulators have increasingly responded to social needs and started to prioritise social welfare as an objective to which the exercise of powers is directed.

The PRA has relaxed adherence to all capital buffer regulations³² so that banks would free up a capital cost of £190bn³³ for lending. The PRA has also clarified that government-backed loans during the pandemic would not be constrained by the leverage ratio,³⁴ essentially providing a 'licence to lend'. Banks are also allowed to fall below the regulatory

²⁷ PRA, 2020. Updating the TFSME to reflect HMT's new Bounce Back Loans Scheme (2 May 2020), from <https://www.bankofengland.co.uk/news/2020/may/updating-the-tfsme-to-reflect-hmt-new-bounce-back-loans-scheme>. The current low level of interest rates ensures the sustainability of UK corporate debt in the short-term although the inflated leverage would make the corporate sector more vulnerable to crisis severity (e.g., earnings shocks). Bailey A., 2020. The future for business investment in the age of Covid and the role of financial services (17 November 2020), speech at TheCityUK National Conference, from <https://www.bankofengland.co.uk/speech/2020/andrew-bailey-the-cityuk-national-conference-2020>.

²⁸ PRA, 2020. Letter from Mel Beaman, Building societies sourcebook – fixed rate lending guidelines (11 August 2020), from <https://www.bankofengland.co.uk/prudential-regulation/letter/2020/building-societies-fixed-rate-lending>.

²⁹ Chiu I.H.Y., 2019. Rethinking the Law and Economics of Post-Crisis Micro-Prudential Regulation- The Need to Invert the Relationship of Law to Economics? *Review of Banking and Financial Law* 38 (2): 639.

³⁰ Masur J.S., Posner E.A., 2017. Should Regulation be Counter-cyclical? *Yale Journal on Regulation* 34 (3): 857.

³¹ Art 128(7), Capital Requirements Directive 2013/36/EU; Arts 412, 429, 430, Capital Requirements Regulation (EU) No 575/2013.

³² PRA, 2020. Q&A on the usability of liquidity and capital buffers (20 April 2020), from <https://www.bankofengland.co.uk/prudential-regulation/publication/2020/buffer-usability-qanda>.

³³ BOE, 2020. Bank of England measures to respond to the economic shock from Covid-19 (11 March 2020), from <https://www.bankofengland.co.uk/news/2020/march/boe-measures-to-respond-to-the-economic-shock-from-covid-19>; PRA, 2020. Statement by the PRA accompanying measures announced by the Financial Policy Committee (11 March 2020), from <https://www.bankofengland.co.uk/prudential-regulation/publication/2020/statement-by-the-pra-accompanying-measures-announced-by-the-fpc>.

³⁴ BOE, 2020. Statement on credit risk mitigation eligibility and leverage ratio treatment of loans under the Bounce Back Loan scheme (4 May 2020), from <https://www.bankofengland.co.uk/prudential-regulation/publication/2020/prs-statement-on-crm-and-leverage-ratio-loans-under-bbbs>.

liquidity ratio³⁵ in order to meet the needs of customers drawing down their credit lines and overdrafts in full. Further, in order to allow lenders to forbear in favour of deferred payments, regulatory treatment of such deferred payments is suspended from the usual conservatism applied to potentially ‘non-performing loans’ (NPLs).³⁶ Deferred payments are not to be treated automatically as non-performing but there is a lack of positive guidance against this negative assessment. Lenders are urged to be sensitive to each debt situation and not be too quick in treating loans as ‘non-performing’ so as to delay any onset of enforcement.

Longer-term hazards of increased household and business indebtedness

The financial regulatory measures carried out by the PRA and FCA support debt forbearance and expansion, largely carried out by banks. Although private sector debtfare is not the only means of provision, and government provision such as through the furlough scheme played a significant part in welfare provision for businesses and households,³⁷ we focus in this paper on the potential ramifications of debtfare and how financial regulators can respond. As such, it is not the aim of this part to critique the comprehensive mix of public and private financing provision that UK policymakers chose, as opposed to available alternatives.

Financial provision for households and corporations has since the 1980s become a matter for competitive markets, and credit has been liberalised radically in the name of financial inclusion³⁸ and potential empowerment for social mobility and economic development.³⁹ In this manner, resorting to yet more private sector debt provision is a structurally dependent strategy during the pandemic, given already-existing high levels of debt.⁴⁰

For households, commentators opine that private debt has become a form of welfare provision⁴¹ in the UK after years of minimisation of state welfare provision.⁴² The rigidity of

³⁵ Masur and Posner, n 30.

³⁶ PRA, 2020. Letter from Sam Woods, Covid-19: IFRS 9, capital requirements and loan covenants (26 March 2020), from <https://www.bankofengland.co.uk/prudential-regulation/letter/2020/covid-19-ifrs-9-capital-requirements-and-loan-covenants>; Statement by the PRA on regulatory capital and IFRS 9 requirements for payment holidays (22 May 2020), from <https://www.bankofengland.co.uk/prudential-regulation/publication/2020/statement-on-application-regulatory-capital-ifrs9>.

³⁷ The ‘Coronavirus Job Retention Scheme’, <https://www.gov.uk/guidance/claim-for-wages-through-the-coronavirus-job-retention-scheme>, which ended on 30 September 2021.

³⁸ Coletta M. et al., 2019. Household Debt in OECD Countries: The Role of Supply-Side and Demand-Side Factors. *Social Indicators Research* 143 (3): 1185.

³⁹ Atkinson A., 2020. Borrowing Equality. *Columbia Law Review* 120 (6): 1403.

⁴⁰ Randell C., 2020. A financial system to support the recovery (16 June 2020), from <https://www.fca.org.uk/news/speeches/financial-system-support-recovery> on high levels of UK household indebtedness; Ernst & Young, 2020. Bank lending to firms surges to a 13-year high as COVID-19 leads to UK businesses borrowing more (10 August 2020), from https://www.ey.com/en_uk/news/2020/08/bank-lending-to-firms-surges-to-a-13-year-high-as-covid-19-leads-to-uk-businesses-borrowing-more.

⁴¹ Palley, n. 8; van der Zwan N., 2014. Making sense of financialization. *Socioeconomic Review* 12 (1): 99.

⁴² Comelli M., 2021. The Impact of Welfare on Household Debt. *Sociological Spectrum* 41 (2): 154.

debt contracts make it attractive for financiers to offer them,⁴³ and the demand side enjoys the benefits of quick access. Further, the period of austerity, introduced after the global financial crisis of 2007-09 which caused national debt to be raised to bail out stricken banks, intensified many households' reliance on debtfare.⁴⁴ Commentators are concerned that debt-based financial provision, which is ploughed into necessary consumption such as healthcare, and other expenditure for social reproduction,⁴⁵ ultimately exacts burdens that are difficult to repay. Such debt is not used to finance investment or acquire assets that would generate future wealth.⁴⁶ In other words, consumption-based debtfare is unlikely to be empowering⁴⁷ but rather it tends to be more extractive in nature.⁴⁸ Increased debtfare under the pressures of the pandemic exacerbates high debt burdens for households whose resilience is doubtful. Credit may be affordable in circumstances of stable revenues, including wages and employment levels, but can become hazardous in uncertain times due to its inflexibility of contractual discipline.⁴⁹ In this light, it is also questioned whether small and medium sized businesses which have rushed to borrow from government-backed schemes are subjecting themselves to long-term hazards and financial woes.⁵⁰

It may be argued that the FCA has worked with institutional investors to relax obstacles to equity fund-raising by companies, hence debt provision is not the exclusive means to access finance by corporations. Institutional investors have agreed to waive pre-emption rights up to 20% of issued share capital.⁵¹ However, compared to regulatory suspensions in favour of debt forbearance and increased lending, the relaxations in relation to equity fund-raising are less extensive.⁵² Although UK companies have taken advantage of

⁴³ Turner, n. 24, ch. 2.

⁴⁴ Gardner J., Gray M., and Möser K. 2020. *Debt and Austerity: Implications of the Financial Crisis*, esp chs 9 and 13. Cheltenham, UK: Edward Elgar.

⁴⁵ De Vita G. and Luo Y., 2021. Financialization, Household Debt and Income Inequality: Empirical Evidence. *International Journal of Finance and Economics* 26 (2): 1917.

⁴⁶ Macey J., 2021. Fair Credit Markets: Using Household Balance Sheets to Promote Consumer Welfare, from <https://ssrn.com/abstract=3781164>.

⁴⁷ Porter K., 2012. The Damage of Debt. *Washington & Lee Law Review* 69 (2): 979, at 1004.

⁴⁸ Baragar F., Chernomas R., 2012. Profits from Production and Profits from Exchange: Financialization, Household Debt and Profitability in 21st-century Capitalism. *Science & Society* 76 (3): 319; Bissonnette J.F., 2019. The Political Rationalities of Indebtedness: Control, Discipline, Sovereignty. *Social Science Information* 58 (3): 454.

⁴⁹ Ramsden D., 2020. The potential long-term effects of Covid (17 November 2020), speech, Institute for Policy and Engagement, University of Nottingham, from <https://www.bankofengland.co.uk/speech/2020/dave-ramsden-speech-public-lecture-for-university-of-nottingham>.

⁵⁰ Lambert P., van Reenan J., 2021. A wave of COVID-related bankruptcies is coming to the UK, LSE Blog, from <https://blogs.lse.ac.uk/businessreview/2021/02/02/a-wave-of-covid-related-bankruptcies-is-coming-to-the-uk-what-can-we-do-about-it/>.

⁵¹ FCA, 2020. Statement of Policy: listed companies and recapitalisation issuances during the coronavirus crisis (8 April 2020), from <https://www.fca.org.uk/news/statements/listed-companies-recapitalisation-issuances-coronavirus>.

⁵² 52. Financial Reporting Council, 2020. Covid-19 Thematic Review (July 2020), from <https://www.frc.org.uk/getattachment/03838acd-facc-4a06-879c-a4682672a6d7/CRR-COVID-19-Thematic-Review-Jul-2020.pdf>.

equity fund-raising opportunities,⁵³ the levels raised may not be sufficient.⁵⁴ Debt provision forms a significant part of the mixture of financial help available to corporations, particularly for small and medium-sized companies.

High levels of indebtedness entail longer-term consequences that could exacerbate corporate and household fragility. There is significant empirical literature that demonstrates how corporations become more financially fragile, i.e., edge closer to the risks of insolvency and distress, due to high levels of indebtedness.⁵⁵ Corporate insolvencies, reflecting micro-level financial fragility, would impede economic recovery and are also related to macro-level fragility in the financial system.⁵⁶ This is because corporate insolvencies and defaults aggravate stress for lenders. At scale, corporate and banking sector problems are symbiotic and can adversely affect the real economy in terms of economic welfare and employment.⁵⁷

Debtfare also heightens financial suffering and fragility⁵⁸ at the household level. Under conditions of economic uncertainty, debt servicing can become a stressful discipline as volatile wages are clamped for debt servicing expenses.⁵⁹ Financial fragility for individuals and households contributes to social cost, including issues of poverty⁶⁰ and homelessness.⁶¹ The global financial crisis crucially showed the tight relationship between dispossessed sub-prime home-owners, a sight of distress during the financial crisis,⁶² and systemic crisis for the banking sector.⁶³ Debt-driven household consumption has declined⁶⁴ during the pandemic, indicating households' caution amidst financial uncertainty. Household financial fragility is

⁵³ Pandemic sparks surge in equity fundraisings (6 June 2020), from <https://www.businessfast.co.uk/pandemic-sparks-surge-in-equity-fundraisings/>. £14.7bn has been raised by UK companies, 'Facing the future – challenges and priorities for the FCA' (12 November 2020), from <https://www.fca.org.uk/news/speeches/facing-future-challenges-priorities>.

⁵⁴ Debt raisings exceed the same period last year by 247%, *ibid*.

⁵⁵ van der Hoog S., 2018. The Limits to Credit Growth: Mitigation Policies and Macroprudential Regulations to Foster Macrofinancial Stability and Sustainable Debt. *Computational Economics* 52 (3): 873.

⁵⁶ Bruneau C., de Bandt O., and El Amri W., 2012. Macroeconomic Fluctuations and Corporate Financial Fragility. *Journal of Financial Stability* 8 (4): 219; Alfaro L. et al., 2019. Corporate Debt, Firm Size and Financial Fragility in Emerging Markets. *Journal of International Economics* 118: 1.

⁵⁷ Davis E.P., 1995. Debt, Financial Fragility and Systemic Risk, 72-73. Oxford: Oxford University Press.

⁵⁸ D'Orazio P., 2019. Income Inequality, Consumer Debt, and Prudential Regulation: An Agent-Based Approach to Study the Emergence of Crises and Financial Instability. *Economic Modelling* 82: 308.

⁵⁹ Bissonnette, n. 48; Mahmud T., 2017. Neoliberalism, Debt and Discipline. In: *Research Handbook on Political Economy and the Law*, edited by Mattei U. and Haskell J.D., ch. 5. Cheltenham, UK: Edward Elgar.

⁶⁰ Ntsalaze L. and Ikhide S., 2017. The Threshold Effects of Household Indebtedness on Multidimensional Poverty. *International Journal of Social Economics* 44 (11): 1471; Roberts A., 2016. Household Debt and the Financialization of Social Reproduction: Theorizing the UK Housing and Hunger Crises. In: *Risking Capitalism*, edited by Zerembka P., Soederberg S., 135-164. Bingley: Emerald Publishing Limited.

⁶¹ Dickerson A.M., 2009. Over-Indebtedness, the Subprime Mortgage Crisis, and the Effect on U.S. Cities. *Fordham Urban Law Journal* 36 (3): 395.

⁶² Ross L.M., Squires G.D., 2011. The Personal Costs of Subprime Lending and the Foreclosure Crisis: A Matter of Trust, Insecurity, and Institutional Deception. *Social Science Quarterly* 92 (1): 140.

⁶³ Davies H., 2010. *The Financial Crisis: Who is to Blame?*, chs 6, 13, 14. London: Polity Press; Longstaff F.A., 2010. The Subprime Credit Crisis and Contagion in Financial Markets. *Journal of Financial Economics* 97 (3): 436.

⁶⁴ Reuters, 2021. UK mortgage lending booms but consumers stay wary about debt (29 July 2021), from <https://www.reuters.com/world/uk/uk-mortgage-lending-rockets-by-record-amount-bank-england-2021-07-29/>.

likely to affect aggregate demand,⁶⁵ thus limiting the corporate sector's economic output and contributing to its financial fragility.

By stepping in to unlock market-based debt provision, financial regulators assume a responsibility to extend their supervisory scrutiny into such a market. This market is not constituted under normal circumstances and raises issues that pose challenges to a narrow reading of regulatory objectives. Credit consumers' welfare outcomes, at social scale, merit the FCA's attention in relation to its consumer protection objective.⁶⁶ Credit consumers' welfare circumstances have dynamically shaped the FCA's regulatory interventions over the years. For example, welfare-based evidence was key to the introduction of a price cap for high-cost short-term credit to mitigate the excesses of lender extraction⁶⁷ and reforms have been introduced to address potential detriment to vulnerable consumers, such as in relation to equity release mortgages,⁶⁸ where mandatory advice must be provided to customers. The extraordinary circumstances of the pandemic should be viewed as an imperative for the FCA to consider further welfare-based interventions.

As for corporate debt, the FCA's insistence that it does not regulate business debt and is unable to moderate the welfare outcomes of business debt, especially small and medium-sized companies' indebtedness, has come under criticism.⁶⁹ In relation to unequal credit relationships between small businesses and powerful lenders, overt critique is made of the treatment of troubled small businesses by the Royal Bank of Scotland's restructuring unit which aimed to maximise lender returns at the expense of the welfare of small business borrowers.⁷⁰ Further, the PRA as micro-prudential regulator, and the BoE, in relation to macro-prudential regulatory policy, can consider the welfare implications of corporate indebtedness as part of their responsibility for maintaining financial stability. It is arguable that financial stability has become a fundamentally finance-focused conception, maintained

⁶⁵ dos Santos P.L., 2013. A Cause for Policy Concern: The Expansion of Household Credit in Middle-Income Economies. *International Review of Applied Economics* 27 (3): 316; Mian A. and Sufi A., 2015. *House of Debt*, ch. 6. Chicago: The Chicago University Press.

⁶⁶ The FCA has one strategic objective and three operational objectives, consumer protection being one of the operational objectives. The others are maintaining market integrity and promoting market competition, see Sects 1B-1E, Financial Markets and Services Act 2000 amended in 2012.

⁶⁷ Such as the price cap for payday lending, FCA, 2015. PS14/16: Detailed rules for the price cap on high-cost short-term credit - Including feedback on CP14/10 and final rules (2 January 2015), from <https://www.fca.org.uk/publications/policy-statements/ps14-16-detailed-rules-price-cap-high-cost-short-term-credit>. See Aldohni A.K., 2017. The UK New Regulatory Framework of High-Cost Short-Term Credit: Is There a Shift Towards a More 'Law and Society' Based Approach? *Journal of Consumer Policy* 40: 321; Fejós A., 2015. Achieving Safety and Affordability in the UK Payday Loans Market. *Journal of Consumer Policy* 38: 181.

⁶⁸ Fox O'Mahony L. and Overton L., 2014. Financial Advice, Differentiated Consumers, and the Regulation of Equity-release Transactions. *Journal of Law & Society* 41: 446.

⁶⁹ Reuters, 2018. MPs 'disappointed' over regulator's inaction on RBS (12 August 2018), from <https://uk.reuters.com/article/uk-rbs-grg/british-lawmakers-disappointed-over-regulators-inaction-on-rbs-idUKKBN1KX0QQ>.

⁷⁰ Arvind T.T., 2021. Too Big to Care? Financial Contracts and the Problem of Transactional Asymmetry. *Law & Contemporary Problems* 84 (1): 35.

primarily for the benefit of financial institutions, not their borrowers.⁷¹ This is reflected on the UK's institutional architecture for financial regulation which appears to prioritise prudential concerns over other regulatory objectives.⁷² Nevertheless, financial stability should be treated as a broader objective that is ultimately consistent with servicing the real economy.⁷³

It may be argued that our expectations are misplaced, as financial regulators should not arbitrarily intervene in private debt contracts, and their roles in addressing financial welfare, which includes distributive implications, are rather limited,⁷⁴ since the legal framework clearly envisages that consumers in principle take responsibility for their own financial welfare.⁷⁵ Nevertheless, advocating for regulatory stewardship of consumer and SME welfare at the aftermath of the pandemic is not inconsistent with the principle that consumers should generally take responsibility for actions within their control. Consumers normally do this at point of sale. But the outworking of a financial product such as debt, being a credence good, is inevitably affected by post-sale circumstances. It is too limited for 'consumer protection' to predominantly engage regulatory scrutiny at point of sale. This explains why the FCA is increasingly articulating the importance of consumer outcomes,⁷⁶ but this development needs to be expanded, as we argue in Section 3.

Financial regulators are in a unique position to be able to scrutinise the micro-level effects of unsustainable debt,⁷⁷ as well as the macro-level negative externalities, which Turner calls 'debt pollution'.⁷⁸ In this manner, regulators are able to take actions within their existing mandates where problems that surface affect consumer protection or financial stability objectives. These do not necessarily amount to 'arbitrary' rewriting of contracts, as systemic stability concerns have justified such limited interventions.⁷⁹ These are also unlikely to amount to distributive policies as financial regulation is unable to engage in radical policy reforms, as such reforms entail legislative action in bankruptcy and insolvency law, private banking law and consumer contract law.

⁷¹ Linarelli J., 2020. Debt in Just Societies: A General Framework for Regulating Credit. *Regulation & Governance* 14 (3): 409.

⁷² According to FSMA 2000, s 3I, the PRA has a veto over actions of the FCA in the case of dually regulated firms.

⁷³ Bieri D.S., 2010. Regulation and Financial Stability in the Age of Turbulence. In: *Lessons from the Financial Crisis*, edited by Kolb R.W., 327. Hoboken, New Jersey: John Wiley & Sons, Inc.

⁷⁴ Gardner J., 2020. Austerity, Inequality and High-Cost Credit: Understanding the Role of A Social Minimum. In: *Debt and Austerity. Implications of the Financial Crisis*, edited by Gardner J., Gray M., and Moser K. Cheltenham, UK: Edward Elgar.

⁷⁵ FSMA 2000, s 3B (1) (d).

⁷⁶ FCA, 2021. A New Consumer Duty (May 2021), from <https://www.fca.org.uk/publication/consultation/cp21-13.pdf>.

⁷⁷ In terms of welfare externalities, see Karaagac E.A., 2020. The Financialization of Everyday Life: Caring for Debts. *Geography Compass* 14 (11): e12541.

⁷⁸ Turner, n. 24, chs 3-4.

⁷⁹ For example, shareholder and creditor bail-in as provided under the EU Bank Recovery and Resolution Directive 2014, and extensive forms of contractual adjustment for institutions during the global financial crisis, discussed in Pistor K., 2013. A Legal Theory of Finance. *Journal of Comparative Economics* 41 (2): 315.

The next two sections discuss the PRA's and FCA's objectives and regulatory powers in addressing the financial welfare needs of corporate (especially SME) and household borrowers in the aftermath of the pandemic.

3. The Hazards of Post-Pandemic Indebtedness and Maximising the FCA's 'Consumer Protection' Objective

This section argues that the FCA's 'consumer protection' objective can be maximised within its existing mandate to address consumer and SME debt management problems. Although consumer credit is regulated, we are concerned that the current legal and regulatory framework, focused on point of sale, does not sufficiently cater for consumer protection needs in terms of welfare and outcomes. This is a long-running issue likely to be exacerbated by the post-pandemic environment. Further, the unregulated nature of business credit for unsophisticated SMEs have already raised problems that may be exacerbated in the post-pandemic environment for their debt management. The section begins by providing a succinct overview of the legal and regulatory framing of consumer credit before critiquing the limitations of the status quo.

The legal and regulatory framework for consumer credit in the UK consists of overlapping layers of common law principles, statutory rules and procedures such as the possibility to bring a complaint to the Financial Ombudsman, and regulatory rules made by the FCA. Special rules often apply to particular segments of the consumer credit market such as mortgages, credit cards, personal loans, overdrafts, payday lending etc.⁸⁰ The existing framework focuses on a narrow form of ex ante consumer protection, at the point of sale, and we are concerned that borrowers may be left to self-help in managing the ex post welfare challenges they may face after the pandemic.

Broadly speaking, the common law position takes as its point of departure that the relationship between a bank and prospective or current borrower is an arm's length business relationship whereby each party is expected to safeguard their own interests and banks are under no general fiduciary or advisory obligation to their customers.⁸¹ However, in narrowly circumscribed contexts, such as the provision of security or a personal guarantee by a person for the debt of a spouse or close relative, the common law provides a degree of ex ante protection through the doctrine of undue influence which requires lenders to ensure that the

⁸⁰ For an overview of the legal and regulatory framework, see Kokkinis A., Miglionico A., 2021. *Banking Law: Private Transactions and Regulatory Frameworks*, chs 5.2, 6, and 9.4. Abingdon: Routledge.

⁸¹ See e.g., *Woods v Martins Bank* [1959] 1 QB 55; *Cornish v Midland Bank* [1985] All ER 513; *Verity and Spindler v Lloyds Bank* [1995] CLC 1557; and *Suriya and Douglas v Midland Bank* [1999] 1 All ER (Comm) 612.

person providing the security or guarantee has received competent legal advice prior to entering into the relevant agreement.⁸²

The common law has been complemented since the 1970s by bespoke consumer protection legislation and financial regulation provided by the FCA. The most prominent piece of legislation is the Consumer Credit Act 1974 which provides certain forms of *ex ante* protection for consumers by subjecting lenders to a licensing regime,⁸³ constraining advertisements,⁸⁴ requiring extensive information disclosure from lenders to prospective borrowers,⁸⁵ and providing cooling off periods.⁸⁶ Further, the FCA imposes *ex ante* protection for consumers in various credit arrangements by compelling lenders to adhere to “responsible lending” which ensures that loans are affordable.⁸⁷

In terms of unsecured consumer credit (excluding overdrafts) the FCA Handbook rules on responsible lending require firms to undertake a reasonable assessment of the creditworthiness of a customer before entering into a regulated credit agreement or significantly increasing the amount of credit or credit limit under such an agreement.⁸⁸ Detailed rules stipulate the factors that lenders need to take into account which include the customer’s income, savings, other assets and overall financial situation. In the case of mortgages, the FCA rules prohibit lenders from entering into consumer mortgage contracts unless they can demonstrate that the mortgage contract is affordable for the customer.⁸⁹ Lenders’ affordability assessments are based on the net income of the customer after expenditures, which refer to committed and basic essential expenditure, and quality-of-living cost of his household.⁹⁰ Income information must be verified and self-certification by the customer is not sufficient.⁹¹ Further, the FCA Handbook mortgage rules include a requirement that lenders behave “honestly, fairly, transparently and professionally, taking account of the rights and interests of the consumers” both when designing products and when offering services and advice to consumers, which derives from the Mortgage Credit Directive.⁹²

⁸² See *Barclays Bank v O’Brien* [1994] 1 AC 180; *RBS v Etridge (No 2)* [2001] 3 WLR 1021; *Barclays Bank v Coleman* [2002] 2 AC 273.

⁸³ Part III of the Act.

⁸⁴ Part IV of the Act.

⁸⁵ Section 55.

⁸⁶ Sections 66A – 73.

⁸⁷ In parallel, the non-binding Standards for Lending Practice include a commitment on behalf of lenders to “lend responsibly and aim to provide a product that is affordable” for each customer. See Lending Standards Board, 2016. Standards for Lending Practice: Personal Customers, from <https://www.lendingstandardsboard.org.uk/the-standards-for-personal-customers/#statement-of-lender-and-borrower-responsibilities>.

⁸⁸ FCA Handbook, CONC 5.2.A.4.

⁸⁹ FCA Handbook, MCOB 11.6.2 (1) (b).

⁹⁰ FCA Handbook, MCOB 11.6.5.

⁹¹ FCA Handbook, MCOB 11.6.8.

⁹² Directive 2014/17/EU of the European Parliament and of the Council of 4 February 2014 on credit agreements for consumers relating to residential immovable property [2014] OJ L60/34, art 7.

The FCA affordability framework on the one hand helps overcome consumers' lack of financial literacy or behavioural irrationality,⁹³ by subjecting borrowers and lenders to a basic and objective calculative matrix. But on the other hand, broad brush economic assumptions are made regarding individuals' financial profiles and needs. The affordability test strikes a balance, allowing consumer credit markets to develop without constraining credit provision too much. The refrain from imposing overly onerous obligations⁹⁴ on lenders works alongside the promotion of consumer choice. The test of affordability is a narrow economic test which also sits well with the objectives of prudential regulation (designed to manage credit risk by lenders). Overall, the *ex ante* regime for consumer credit avoids excessive paternalism and facilitates consumers' choice and access. This regime focuses upon point of sale, hence, debtfare outcomes, which can only be discerned over a period of time, are not necessarily scrutinised by regulators and left to borrowers and lenders to negotiate.⁹⁵

There are relatively vaguer forms of protection for consumers in the post-sale stage after the credit arrangement has been entered into. First, the Consumer Rights Act 2015, which incorporates rules that originated from the relevant European Directive,⁹⁶ empowers the courts to review the fairness of any secondary term in consumer contracts that was not individually negotiated on the basis of a "significant imbalance" test.⁹⁷ Essential terms such as those relevant to the price of the product are excluded from fairness review. UK courts have interpreted the notion of essential terms broadly as long as consideration elements are found, so consumers are deprived of challenge for such terms that inevitably affect their welfare and outcomes.⁹⁸ This ruling is emblematic of the stance of English courts against expansive judicial intervention into private bargains.

⁹³ For empirical findings on the inability of most consumers to select the best credit card option for their needs, see Doyle M-A., 2018. Consumer Credit Card Choice: Costs, Benefits and Behavioural Biases. Reserve Bank of Australia Research Discussion Paper 2018-11, from <https://www.rba.gov.au/publications/rdp/2018/2018-11/literature.html>.

⁹⁴ Exceptions to this approach can be found in the caps imposed on the cost of overdrafts and payday loans. With effect from April 2020 banks are prohibited from charging fixed fees for all unarranged overdrafts: they can only charge annual interest. Banks are prohibited from charging a higher rate of interest for unarranged overdrafts than the rate that they charge for arranged overdrafts. In parallel, since 2015 the cost of payday loans has been capped by the FCA to 0.8% per day (both interest and fees) while default fees are capped at £15 and the total cost of interests and fees for a loan is capped at 100% of the amount borrowed. FCA, 2019. High-cost Credit Review: Overdrafts policy statement, PS19/16 [1.8] from <https://www.fca.org.uk/publication/policy/ps19-16.pdf>. FCA, 2014. Detailed rules for the price cap on high-cost short-term credit, Policy Statement PS14/16, from <https://www.fca.org.uk/publications/policy-statements/ps14-16-detailed-rules-price-cap-high-cost-short-term-credit>.

⁹⁵ On the need for greater regulatory paternalism beyond the point of sale, in the context of investment products, see Chiu I. H-Y., 2021. More paternalism in the regulation of consumer financial investments? Private sector duties and public goods analysis. *Legal Studies*. doi:10.1017/lst.2021.29.

⁹⁶ Council Directive 93/13/EEC of 5 April 1993 on unfair terms in consumer contracts [1993] OJ L95/29.

⁹⁷ Consumer Rights Act 2015, section 62(6).

⁹⁸ The Supreme Court has ruled that unauthorised overdraft charges are an essential part of the reward that banks receive for offering a range current account services and, therefore, that their fairness cannot be reviewed by the courts. See *OFT v Abbey National plc* [2009] UKSC 6. See also the ruling of the House of Lords in *DG of Fair Trading v First National Bank plc* [2002] 1 AC 481 on the ability of the courts to review the fairness of terms that apply contractual interest rate after judgment until the judgement debt is paid in full.

Second, the Consumer Credit Act 1974, as amended by the Consumer Credit Act 2006,⁹⁹ grants the court a very wide jurisdiction to review the fairness of the terms of credit agreements as well as the fairness in the manner lenders exercise their legal rights.¹⁰⁰ Contrary to the Consumer Rights Act, fairness review under the Consumer Credit Act encompasses the essential terms of the consumer credit agreement. However, the Supreme Court has interpreted this provision rather narrowly. The mere fact that some features of the transaction operate harshly against the debtor does not render the relationship unfair, as such features “may be required in order to protect what the court regards as a legitimate interest of the creditor”.¹⁰¹ Further, the Court clarified that inequality in financial knowledge and expertise alone is not sufficient reason to reopen a transaction as this “cannot have been Parliament’s intention”.¹⁰²

Third, the statutory framework has established an extrajudicial dispute resolution mechanism allowing financial services consumers to bring complaints to an independent body known as the Financial Ombudsman Service (FOS)¹⁰³ which has the power to make monetary awards of up to £350,000.¹⁰⁴ As the FOS decides disputes on the basis of fairness or reasonableness¹⁰⁵ without necessary reference to legal standards, it is arguable that consumers can seek ex post protection from credit arrangements that no longer work optimally for their welfare in due course. However, we observe that FOS decisions are very much influenced by the affordability test regime. Although consumers who became over-extended due to lenders’ neglect to check their financial circumstances obtained refunds and redress,¹⁰⁶ it is less certain whether ex post redress is available where there are no apparent ‘point-of-sale’ issues. Would the FOS be able for example to readjust borrowers’ terms if their circumstances change, to affect the nature of the credit bargain?

Finally, although the FCA principles for business – such as the duty of firms to treat customer fairly and provide them with clear and fair information – governs lenders’ consumer-facing behaviour, principles-based enforcement operates at the level of the relationship between firms and regulator and does not provide direct redress to consumers.

⁹⁹ Previously only extortionate credit bargains could be reopened by the courts. This set a very high bar for debtors that sought to challenge the terms of their credit agreements.

¹⁰⁰ Sections 140A – 140D. See also sections 137 -140 on extortionate credit bargains.

¹⁰¹ *Plevin v Paragon Personal Finance Limited* [2014] UKSC 61, [10] per Lord Sumption.

¹⁰² *Ibid.*

¹⁰³ Dispute resolution through the FOS brings the benefits of speed, simplicity, and low cost, as there is no need to seek legal advice and use of the service is free.

¹⁰⁴ FSMA 2000 s 229 (4) and (6). FCA Handbook, DISP 3.7.4. Note that from 1 April 2020 onwards the limit will be adjusted annually to reflect inflation (CPI increase) rounder down to the nearest £5,000.

¹⁰⁵ Complaints brought under the FOS compulsory jurisdiction must be determined “by reference to what is, in the opinion of the ombudsman, fair and reasonable in all the circumstances of the case”. FSMA s 228 (2). However, although not bound by them, the FOS must take into account relevant laws, regulations, regulatory rules, regulatory guidance and standards, codes of practice and good industry practice. See FCA Handbook, DISP 3.6.4.

¹⁰⁶ FOS, 2021. Case Studies: A borrower tells us she was provided with a loan she couldn’t afford, from <https://www.financial-ombudsman.org.uk/case-studies/borrower-tells-us-provided-loan-couldnt-afford>.

Overall, it is evident that ex post review of credit agreements has not delivered much in practice despite its broad legal framing. Therefore, the ex post reworking of a credit agreement is actually very difficult, and consumers have no assurance that lenders will take a flexible relational approach if their circumstances and needs change at the post-sale stage, requiring a dramatic adjustment of the credit bargain.

In relation to business lending, borrowers enter into an arm's-length relationships with lenders, and these relationships are not subject to ex ante or ex post regulatory protections. There is, however, an element of ex post protection for small businesses which can now bring complaints to the FOS.¹⁰⁷ We argue that leaving credit bargains, for the greater part, to arm's-length competitive market dynamics can create problems of under-protection for business borrowers like SMEs, as they often cannot afford to seek independent advice while transactions are becoming more complex, such as in the case of interest-rate hedging products offered to SMEs prior to the global financial crisis.¹⁰⁸ Bugeja argues that SME business customers need a similar level of protection as that afforded to retail customers, and the false dichotomy between consumers and business customers needs to be revisited.¹⁰⁹ Such long-standing gaps in the protection of SME borrowers are likely to be highlighted in the immediate future as a result of the increased debt burden that has been amassed during the pandemic.

The existing legal and regulatory regimes for credit provision could come under strain if borrowers' post-pandemic needs become heightened. The FCA however envisages a self-regulatory approach to lenders' management of borrowers' debts post-pandemic. Principally, for consumer credit, the FCA expects that customers who are coming to the end of payment deferrals should seek tailored arrangements with their lenders. For mortgage arrangements, perhaps due to the legacy lessons of the collapse of the sub-prime mortgage market in 2007,¹¹⁰ the FCA has provided guidance that lenders need to treat customers fairly, and not to give primacy to their commercial interests. Lenders are not to resort quickly to 'recapitalisation' measures which may lead to the risk of borrowers losing their homes. Options are spelt out in relation to flexibility in tailored arrangements, such as term extension

¹⁰⁷ FCA, 2018. Small Business (Eligible Complainant) Instrument 2018, FCA 2018/61, from https://www.handbook.fca.org.uk/instrument/2018/FOS_2018_7.pdf.

¹⁰⁸ See the unsuccessful civil challenges by SMEs against their lenders, *Crestsign Ltd v Natwest and RBS* [2014] EWHC 3043 (Ch); *Thornbridge Limited v Barclays Bank Plc* [2015] EWHC 3430 (QB); and FCA, 2016. *Review of Interest Rate Hedging Products*, from <https://www.fca.org.uk/consumers/interest-rate-hedging-products>.

¹⁰⁹ Bugeja D., 2019. *Reforming Corporate Retail Investor Protection: Regulating to Avert Mis-Selling*. Oxford: Hart Publishing. Bugeja demonstrates that many SMEs do not fully understand the implications of execution-only transactions and exclusion clauses, which are drafted in technical legal language and are hard to permeate for non-experts. Many of these arguments also stand true in the case of credit arrangements which often exhibit complexity. Furthermore, and unlike investment products, credit agreements are often entered into in circumstances where SMEs face liquidity pressures and have little option than to accept the terms imposed by the lender in order to stay afloat. Thus, issues of asymmetry of information and expertise are compounded by asymmetry in bargaining power and absence of viable alternatives.

¹¹⁰ Brener A., 2020. *Housing and Financial Stability: Mortgage Lending and Macroprudential Policy in the UK and US*, ch. 4. London: Routledge.

and moving to alternative repayment plans and amounts. The FCA has also provided guidance¹¹¹ for other consumer credit customers, urging tailored arrangements involving forbearance, new credit arrangements that are financially sustainable and making repossession, where relevant, a last resort. Lenders should, even if short of providing advice to borrowers, comply with certain communication standards and direct borrowers to seek debt advice or consult the information provided by the publicly accessible Money Advice Service.

The FCA's governance of 'tailored arrangements' is arguably the cornerstone of post-pandemic consumer protection. However, tailored arrangements are subject to market-based governance due to lenders' incentives to maximise recovery, and lenders' prudential compliance needs.¹¹² These incentives arguably work against meeting borrowers' possibly heightened needs in post-pandemic recovery. For consumer borrowers, post-pandemic debt management may become more challenging in relation to household financial welfare more holistically. Lenders are likely to offer tailored arrangements based on affordability, which draws upon the existing cornerstone of consumer credit protection. 'Affordability' can be narrowly and economically construed, and this approach may not address borrowers' financial welfare needs in a more holistic manner. Assumptions about income may not hold during the uncertainties of post-pandemic recovery, and there may be other sharpened needs or strains with regard to borrowers' wider circumstances such as family members' financial needs. In this regard, post-pandemic consumer debt management exposes what is already limited in consumer credit regulation, i.e., a narrow focus on the calculus of what reasonably can be extracted by lender, and not necessarily the well-being and ultimate outcomes for the borrower.¹¹³

Research on financial well-being is often not reflected in commercial or regulatory practice,¹¹⁴ while commentators have called upon both to recognise that financial well-being comprises¹¹⁵ objective economic concepts such as income levels and ratio of debt, as well as subjective concepts¹¹⁶ such as empowerment¹¹⁷ and satisfaction in how finance facilitates an overall sense of well-being. Consumers' debt management needs may sharpen during the post-pandemic phase in addition to possible changes in household, workplace and other

¹¹¹ FCA, 2020. Consumer Credit and Coronavirus: Tailored Support Guidance (November 2020), from <https://www.fca.org.uk/publication/finalised-guidance/consumer-credit-coronavirus-tailored-support-guidance.pdf>.

¹¹² Discussed in greater detail in Section 4.

¹¹³ Baker T. H. and Stone C., 2020. Making Outcomes Matter: An Immodest Proposal for a New Consumer Financial Regulatory Paradigm. *The Business and Finance Law Review* 4 (1): 1.

¹¹⁴ Collins J. M. and Urban C., 2020. Measuring Financial Well-Being Over the Lifecourse. *The European Journal of Finance* 26 (4-5): 341.

¹¹⁵ Ibid.

¹¹⁶ Sorgente A., Lanz M., 2019. The Multidimensional Subjective Financial Well-Being Scale for Emerging Adults: Development and Validation Studies. *International Journal of Behavioural Development* 43 (5): 466.

¹¹⁷ Vlaev I., Elliott A., 2014. Financial Well-being Components. *Social Indicators Research* 118: 1103. <https://doi.org/10.1007/s11205-013-0462-0>.

arrangements. It is queried whether lenders' tailored arrangements would accommodate these other 'social' and subjective factors in absence of regulatory guidance, and whether adherence to affordability as the narrow lynchpin of consumer protection would be productive or counterproductive for ultimate consumer welfare. As regulators' provision of payment holidays was a matter of right and a form of intervention to protect short-term welfare, such an approach is pro-social in nature. It is queried if extended pro-social thinking should continue in terms of regulators' scrutiny and supervision of post-pandemic consumer debt management.

It may be argued that the FCA already imposes on firms the obligation to screen customers for vulnerability and to treat them accordingly in order to avoid bad outcomes.¹¹⁸ In this manner, consumer protection is safeguarded in existing regulatory approaches. Further, the FCA's proposed clarification on the 'new Consumer Duty'¹¹⁹ would also orient firms towards outcomes-based consumer protection. We argue however that both are likely insufficient. First, vulnerability is focused on characteristics such as mental or physical infirmity, stage of life upheaval, low personal resilience and low financial capability.¹²⁰ This is a narrower set of vulnerability characteristics than identified in Cartwright's taxonomy, which extends to contextual circumstances such as family situations and industry structures that are disadvantageous to financial customers.¹²¹ Even in the narrower sense of vulnerability, stage of life upheaval or low financial resilience could characterise many borrowers in light of the circumstances brought on by the lockdowns and economic uncertainties ahead. Although the FCA has ramped up the obligation for financial intermediaries to assess vulnerability,¹²² a broader framing of vulnerability is still lacking. There is scope for the FCA to expand the application of vulnerability assessments and consider subjecting tailored arrangements to mandatory advice. The imposition of such a duty would entail heightened obligations of care and regulatory discipline for lenders, therefore re-orienting lenders to the changed needs of their customers. For example, Macey¹²³ argues that fiduciary-type duties of lenders should be extended to borrowers who are in need of essential consumption in order to minimise lenders' extractive opportunities and behaviour.

¹¹⁸ FCA, 2021. Guidance for Firms on the Fair Treatment of Vulnerable Customers (March 2021), from <https://www.fca.org.uk/publications/finalised-guidance/guidance-firms-fair-treatment-vulnerable-customers>, 9.

¹¹⁹ FCA, 2021. A New Consumer Duty (May 2021), from <https://www.fca.org.uk/publication/consultation/cp21-13.pdf>.

¹²⁰ Note 118.

¹²¹ Cartwright P., 2015. Understanding and Protecting Vulnerable Financial Consumers. *Journal of Consumer Policy* 38: 119, <https://doi.org/10.1007/s10603-014-9278-9>. Also see Aldohni A.K., 2014. Loan Sharks v. Short-term Lenders: How Do the Law and Regulators Draw the Line? *Journal of Law & Society* 40 (3): 420 on supply vulnerability describing the lack of choice in markets as affecting consumers' decision-making.

¹²² FCA, n. 118, p. 8.

¹²³ Macey, n. 46.

Next, the FCA's proposal for a new Consumer Duty is aimed at transcending the procedural nature of the earlier 'treat customers fairly' initiative.¹²⁴ The Consumer Duty comprises a general high-level principle of consumer protection, underpinned by cross-cutting rules in all sectors to help consumers avoid foreseeable harm and to be empowered to meet their financial objectives. These rules would seek to achieve outcomes for consumers relating to clear and fair communications, products and services that meet their objectives, achieving value for price. Although the new Duty seems to focus on outcomes, one can be sceptical about how far the new Duty addresses financial well-being as discussed above. The concept of consumer protection in the new Duty remains focused on promoting market choice and preventing mis-selling, concentrating upon point-of-sale as the most important juncture for consumer decision. This is inconsistent with financial goods and services as credence goods, whose quality and how that affects well-being, should be matters subject to ongoing assessment and even adjustment to meet consumers' changing circumstances. It is uncertain to what extent the new Duty encompasses ongoing review for consumers and the implications for how firms should treat them. *Ex post* adjustments needed in consumer debt management are a relational and not market-based construct, and the needs of financial well-being, especially in terms of consumers' subjective sense of welfare, sustainability and control, arguably remain unaddressed in this framework.

It may be argued that requiring lenders and regulators to incorporate the broader 'financial well-being' outcomes in their practices would be onerous and would implicitly remove from consumers their sense of responsibility for financial decision-making. We do not agree. Existing regulation such as market-based governance in disclosure and advisory regulation assist consumers at the point of purchasing financial products, such as debt, but the outworking of debt relations is dynamic and can be complex for consumers. Consumers in an existing debt relationship have little market power to bargain with their lenders, and can be susceptible to neglect or loss of financial well-being in ongoing arrangements challenged by changing circumstances.

The Bank of England's recent survey¹²⁵ however shows that many consumers who took payment holidays have resumed payment and that the self-regulatory implementation of tailored arrangements seems to not have given rise to problems of a social scale. However, the majority picture may obscure pockets of welfare adversity experienced by individuals or households- should these merely be attributed to a matter of individual fortunes and luck? Wilhelmson argues that 'social force majeure' which combines relational contractual aspects with a sense of public interest, could warrant regulatory intervention in order to mitigate

¹²⁴ Gilad S., 2014. Beyond Endogeneity: How Firms and Regulators Co-Construct the Meaning of Regulation. *Law and Policy* 36 (2): 134.

¹²⁵ Bank of England, 2021. How have payment holidays supported mortgage borrowers during the Covid crisis? (9 Aug 2021), from <https://www.bankofengland.co.uk/bank-overground/2021/how-have-payment-holidays-supported-mortgage-borrowers-during-the-covid-crisis>.

welfare adversities.¹²⁶ Although our recommendations in Section 5 do not amount to a redistributive proposal,¹²⁷ which is beyond the scope of this article, regulators are in a position to scrutinise and perhaps mitigate welfare hardships, within their existing powers.

We turn to business credit which more likely raises issues at a social scale. Business credit is unregulated,¹²⁸ and the interest-rate hedging product mis-selling episode has highlighted sharp commercial practice where lenders introduce comprehensive exclusion clauses and leave small businesses in particular to take on complex credit arrangements without advice. Nevertheless, policymakers have continued to make debtfare the primary source of financial provision for businesses during the pandemic, albeit introducing government guarantees for commercially administered lending. Although the FCA insists on the ad hoc nature of intervention into problems with business credit,¹²⁹ the question must be raised as to whether the lack of regulatory supervision for business lending, particularly where power asymmetry exists, remains viable.¹³⁰ There are already concerned voices regarding the hazards of excessive business debt¹³¹ and the management of such debt is likely to be an issue of social concern. Lenders can be perversely incentivised to accelerate treatment of troubled debt into distress or default in order to call upon the government guarantees. This can have devastating consequences for industries, jobs and social stability. In this manner, it is queried if narrow conceptions of lender or financial stability conflict with wider social objectives of economic and social well-being.

The FCA's stewardship of its consumer protection objective needs to adapt to current social demands in terms of recognising how consumers conceive of financial welfare and what the scope of 'consumers' should be. But, beyond the potential for the FCA to maximise the 'consumer protection' objective in scrutinising consumer and SME debt management, it is arguable that the consumer protection objective cannot be fully realised without appreciating how prudential regulation interacts with it. Prudential regulation affects how lenders engage with borrowers' debt management, hence, debt management solutions give rise to both financial welfare and prudential concerns. The FCA's consumer protection mandate relating to welfare consequences of indebted households cannot be fully explored without an integrated perspective with the PRA's prudential regulatory objectives. This is needed even if

¹²⁶ Wilhelmsson T., 1990. "Social Force Majeure" – A New Concept in Nordic Consumer Law. *Journal of Consumer Policy* 13: 1. <https://doi.org/10.1007/BF00411866>.

¹²⁷ Distributive solutions to implement luck egalitarianism, which is the proposal that people should be compensated as a matter of distributive justice for bad luck that results in their adversity through no 'responsibility' within their control, are discussed in Linarelli, n. 71; Hurley S.L., 2005. *Justice, Luck and Knowledge*. Mass: Harvard University Press.

¹²⁸ Tew I., 2019. FCA urged to regulate commercial lending (14 June 2019), from <https://www.ftadviser.com/regulation/2019/06/14/fca-urged-to-regulate-commercial-lending/>.

¹²⁹ Which is reviewed by Swift J. QC, 2021. Independent Review of Interest Rate Hedging Products, from <https://www.fca.org.uk/transparency/independent-review-interest-rate-hedging-products>.

¹³⁰ Bugeja, n. 109.

¹³¹ Butler S., 2021. Tsunami of closures' threaten UK high streets as debt grows fivefold (The Guardian, 16 July 2021), from <https://www.theguardian.com/business/2021/jul/16/tsunami-of-closures-threaten-uk-high-streets-as-debt-grows-fivefold>.

the regulatory architecture in the UK is one of “twin peaks” where these two objectives are regarded as capable of being stewarded independently but only to some extent as the legal framework provides for mandatory coordination between the PRA and FCA.¹³² The possibly distinct trajectories of these objectives may be more pronounced in normal times, but stressful situations highlight their interface and the need for a coordinated response.

The next section discusses how the PRA and FCA should consider extending their existing mandatory coordination to meet the challenges of the times, rather than be hindered by the twin peaks regulatory architecture. We turn to discuss the PRA’s mandate and how its powers can be exercised to incorporate considerations of financial welfare on the demand side of the credit economy.

4. The Role of the PRA in Managing the Hazards of Post-Pandemic Indebtedness: Financial Welfare Affects Financial Stability

The PRA’s prudential regulatory regime has treated private sector borrowing as a matter of bank risk management and overall financial stability, hence, access to finance is facilitated so long as bank resilience is unaffected. However, the PRA recognises that maintaining stringent regulatory requirements for resilience would make banks risk averse. Hence, microprudential regulation has been relaxed as discussed in Section 2.¹³³

Relaxation of microprudential regulation comes with some risk to the PRA’s financial stability objective, if banks will increasingly have to deal with the problem of distressed loans, as the pandemic continues. The prudential framing of NPLs is a highly economic and disengaged exercise from the ‘human’ and ‘social’ aspects of each loan. The definition of NPLs hinges upon a standardised ‘past due’ characterisation, of a certain number of days, normally 90 days.¹³⁴ In such a characterisation, there is no importing of any embedded sociological or humanising account of the nature and difficulties of the loan. Such treatment can arguably lead to a form of rigidity in prudential compliance, although such rigidity, under circumstances where agency costs loom large in loan underwriting and excessive risk-taking,¹³⁵ can also be warranted. In relation to household and small business borrowing, agency costs arising out of close business relationships between certain large corporate borrowers and bank senior management or controlling shareholders, that may unduly influence bank lending, are an

¹³² Sections 3D, 3E, Financial Services and Markets Act 2000.

¹³³ PRA, 2020. PRA statement on Covid-19: IFRS 9 and capital requirements (26 August 2020), from <https://www.bankofengland.co.uk/prudential-regulation/publication/2020/statement-covid19-ifs9-capital-requirements-specific-payment-deferrals>.

¹³⁴ Bholat D. et al., 2016. Non-performing Loans: Regulatory and Accounting Treatments of Assets’, Bank of England Staff Working Paper, No. 594, from <https://www.bankofengland.co.uk/-/media/boe/files/working-paper/2016/non-performing-loans-regulatory-and-accounting-treatments-of-assets.pdf>; European Central Bank, 2017. Guidance to banks on non-performing loans (March 2017), from https://www.bankingsupervision.europa.eu/ecb/pub/pdf/guidance_on_npl.en.pdf.

¹³⁵ Kokkinis A., Miglionico A., 2020. The Role of Bank Management in the EU Resolution Regime for NPLs. *Journal of Financial Regulation* 6 (2): 204.

unlikely phenomenon due to the essential power asymmetry between such borrowers and banks.

Indeed, it is the aggregate treatment of borrowers, as part of standard NPL management, by ignoring their personal and social circumstances, that is a cause for concern. The personal and social circumstances of a borrower are intrinsic to the characterisation of a loan, and a 'numerical' perspective of the loan and its viability for prudential assessment may obscure concerns of financial welfare. Relentlessly quantitative treatment of NPLs can destroy the individual and social value of loans, adversely affecting economic value. Further, such treatment is arguably incompatible with the relational nature of credit contracts,¹³⁶ especially long-term ones like mortgages, but also with the social contract underlying the statutory objectives of financial regulation. There are large questions for prudential regulation in adjusting to the realities of financial welfare needs in light of the pandemic, in relation to its boundaries, their flexibility, and what such flexibility entails in the long-term,¹³⁷ with respect to upholding market confidence and bank safety as a regulated phenomenon.¹³⁸ To acknowledge this, as well as dynamically to engage the needs of borrower financial welfare in working out adjustments in prudential regulation, seem to be necessary steps forward.

The PRA has urged banks to, first, not treat deferred loans as non-performing, as many of these deferrals have not been carried out with due diligence. Banks are then asked to work out tailored arrangements with troubled borrowers, including deferred ones. It is questioned how such tailored arrangements can be optimal when banks labour under the regulatory burden of conservatively provisioning for NPLs. The financially-based governance of micro-prudential regulation is not currently flexible enough to take into account socially-infused factors such as borrowers' longer-term financial welfare, perhaps by longer periods of forbearance or even loss-sharing or distributive arrangements, in order to achieve longer-term win-win solutions that are both financially and socially optimal.¹³⁹ We argue that there is scope for the prudential governance of NPLs to embed insights from a broadly-defined consumer protection objective that includes financial welfare outcomes for borrowers. In this manner, as banks implement tailored arrangements for troubled borrowers, a combination of customer-protection and prudential objectives can be achieved that also responds to social needs.

We argue that the dominantly economic basis for the prudential management of NPLs can be enriched by insights in economic sociology, and this provides a theoretical basis that also connects prudential regulatory objectives with the socially-facing one of consumer protection. Economic sociology treats economic relationships and the value that they create

¹³⁶ Campbell J.Y. et al., 2011. Consumer Financial Protection. *Journal of Economic Perspectives* 25 (1): 91.

¹³⁷ Chiu I.H.Y., Kokkinis A, Miglionico A., 2021. Relief and Rescue: Suspensions and Elasticity in Financial Regulation, and Lessons from the UK's Management of the Covid-19 Pandemic Crisis. *Stanford International Policy Review* 64: 63.

¹³⁸ Chiu, n. 29.

¹³⁹ Sandbu M., 2020. UK needs more fiscal planning in a pandemic, not less, (Financial Times, 25 October 2020), from <https://www.ft.com/content/14a62562-a0d6-4d85-939b-3b92cc85a3fd>.

as being embedded in social phenomena and relationships.¹⁴⁰ The richness of human stories underlying each hazardous loan or NPL is likely multifaceted, and there is arguably a case for enriching the treatment of NPLs by considering how the social footprint or profile of troubled loans interacts with ‘hard’ economic value. For example, some hazardous loans may bear public interest related social underpinnings such as support for small, innovative or risky businesses, or communities and households with heightened needs. If the broader social value of borrowers¹⁴¹ is taken into account of, besides the economic or financial value of loans, the prudential treatment of such loans may be adjusted in light of the needs of borrower protection objectives. It may be queried how such ‘social value’ is to be conceived. We submit that social value should incorporate the broader subjective conceptions of financial well-being discussed in Section 3, particularly for household borrowers, and in relation to business borrowers, lenders should take into account of their social and community footprint, for example, in relation to their service to their local community, innovative potential, provision of local jobs etc. The infusion of these perspectives is an economic sociological approach that can enrich lenders’ and regulators’ conceptions of NPLs and their strictly economic-based forms of prudential management.

We submit that the above approach to prudential management of troubled loans, and the PRA’s prudential oversight of lenders engaged in this, is particularly important for business lending. Business lending, which represents the bulk of the debt expansion facilitated by the PRA’s suspensions of prudential regulations, is unregulated by the FCA in terms of conduct.¹⁴² In this regard, the default regulatory paradigm is prudential regulation only. It is not practicable for the PRA as the prudential regulator to ignore conduct issues attendant to lending and loan enforcement, as the nature and demands of prudential regulation shape lender behaviour. Banks have already lined up debt collection services for the Bounce Back Loan Scheme borrowers, although they are not envisaged to make repayments until after 12 months.¹⁴³ Financial adversities for the business sector inevitably affect households and their welfare. Hence, we raise the questionability of a binary approach between business and household lending, and more generally of a binary approach between prudential and conduct regulation. Although ‘bad’ business lending can be associated with

¹⁴⁰ Granovetter M., 1985. Economic Action and Social Structure: The Problem of Embeddedness. *American Journal of Sociology* 91 (3): 481.

¹⁴¹ Eidenmüller H., Valbuena J., 2021. Towards a Principled Approach for Bailouts of COVID-distressed Critical/Systemic Firms, European Corporate Governance Institute - Law Working Paper No. 571/2021, from http://ssrn.com/abstract_id=3795942 in relation to preserving businesses.

¹⁴² Broadly speaking, there are two types of regulation: Regulation based on statute (‘public regulation’) and regulation based on contract law and other common law rules and principles (‘private regulation’). Contract law, tort law and private law claims serve as instruments for the regulation of business lending. See on this discussion MacNeil I., 2012. *An Introduction to the Law on Financial Investment*, 2nd edition, ch. 14.2. Oxford: Hart Publishing.

¹⁴³ Megaw N., Morris S., and Thomas D., 2020. Banks look to debt collectors to recover bounce back loans (Financial Times, 24 October 2020), from <https://www.ft.com/content/52f6ad43-abee-4a5b-929e-921dc4278122>.

exposures by banks to favoured clients, connected companies and associate entities with banks' shareholders and management,¹⁴⁴ there are small and medium-sized business customers who do not operate at peer level to banks and can be rendered highly fragile by the unfavourable outworking of difficult or complex contractual terms.¹⁴⁵

We also suggest that financial welfare needs can feed into the PRA's oversight of financial stability, on the instrumental basis that financial stability ultimately relies on social stability.¹⁴⁶ Ultimately, financial stability is symbiotic with real financial welfare on the part of the financial system's participants.¹⁴⁷ A financial system that meets real financial welfare needs is trusted and sustains social stability, which in turn supports financial system stability, that then continues to support long-term growth and poverty-reduction.¹⁴⁸ Hence, the PRA should scrutinise lenders' management of NPLs in a manner infused with consumer protection insights from the FCA's supervisory experience. Both regulators should engage in joint supervision in scrutinising the welfare consequences of post-pandemic debt. Regulatory coordination is, therefore, pivotal to integrating *socially-facing* financial regulation to the PRA's predominantly *industry-facing* regulatory objectives. This is our key normative insight which we develop in Section 5.

It may be argued that, although economists accept that financial stability is necessary for financial welfare and social stability,¹⁴⁹ the reverse relationship – that financial welfare is in the long run a necessary condition for financial stability – is a novel point. At first blush, welfare-oriented policies, such as socially-infused approaches to conduct of business or distressed debt regulation appear to be dangerous for the safety and soundness of individual banks and hence for financial stability, as prolonged forbearance and debt write-offs can exacerbate banks' losses and weaken their balance sheets.¹⁵⁰ This appears to be the foremost concern of prudential regulators at the moment.¹⁵¹ Nevertheless, neglecting welfare

¹⁴⁴ Agency problems underlying corporate lending, Kokkinis and Miglionico, n. 135; Schivardi F., Sette E., and Tabellini G., 2017. Credit Misallocation during the European Financial Crisis, BIS Working Paper No 669, from <https://www.bis.org/publ/work669.pdf>.

¹⁴⁵ Bugeja D., 2019. *Reforming Corporate Retail Investor Protection: Regulating to Avert Mis-Selling*, ch. 2. Oxford: Hart Publishing.

¹⁴⁶ Siems M., Schnyder G., 2014. Ordoliberal Lessons for Economic Stability: Different Kinds of Regulation, Not More Regulation. *Governance* 27 (3): 377, at 387.

¹⁴⁷ Bieri, n. 73, p. 327, suggesting that consumer protection and welfare considerations underlie financial stability as a public good and regulatory objective; Black J., 2013. Reconceiving Financial Markets-From the Economic to the Social. *Journal of Corporate Law Studies* 13 (2): 401, at 413; Chant J., 2003. Financial Stability as a Policy Goal. In: *Essays on Financial Stability*, edited by Chant J. et al., Bank of Canada, Technical Report No. 95, 22.

¹⁴⁸ Guillaumont Jeanneney S., Kpodar K., 2008. Financial Development and Poverty Reduction: Can There Be a Benefit Without a Cost? IMF Working Paper WP/08/62, 5-6, from <https://www.imf.org/external/pubs/ft/wp/2008/wp0862.pdf>.

¹⁴⁹ Allen W.A., and Wood G., 2006. Defining and Achieving financial Stability. *Journal of Financial Stability* 2 (2): 152, 154; Schinasi G.J., 2004. Defining Financial Stability (October 2004), IMF Working WP/04/187, 9-10, <https://www.imf.org/external/pubs/ft/wp/2004/wp04187.pdf>.

¹⁵⁰ Kokkinis and Miglionico, n. 135, p. 218.

¹⁵¹ McCaul E., 2020. Who pays the piper calls the tune: The need for and benefit of strong credit risk management (4 December 2020), ECB Supervision Blog, from

considerations and resorting to harsh enforcement comes at a cost at the macro level. The short-termist need to liquidate and protect immediate monetised value for banks can damage the real economy in terms of hindering economic recovery, in addition to the harm suffered by borrowers. In this manner, pitting financial welfare needs against financial stability is misplaced. For example, harsh enforcement of debt obligations can create a feedback loop whereby the financial hardship experienced by certain borrowers translates into financial difficulties for other borrowers, such as other borrowers in a similar industry who can be affected by contagion of adverse perception. Further, SMEs and other organisations are major employers in their local communities, and their liquidation could lead to loss of employment, household incomes and hazards for household debt. This can result in a lose-lose situation where both the real economy and banks suffer more economic and financial hazards than necessary.¹⁵² Indeed, uncoordinated but simultaneous debt enforcement actions generally cause a depressing effect upon collateral prices, exacerbating financial fragility for banks. Hence, we argue that financial welfare considerations are key to banks' own micro-prudential management and overall stability in the financial sector.

However, it can be argued that fair valuations of assets at market value are required in the micro-prudential regulatory treatment of NPLs in order to prevent banks from hiding NPLs. The accounting standard for such assets makes it impossible for banks to prudentially manage hazardous loans in any other way. We acknowledge that numerical forms of governance provide boundaries to solve one problem, but they create problems of another nature.¹⁵³ Where hazardous loan management may become a problem at social scale after the pandemic, the flexibility required in policy adjustment may be across-the-board and not merely transactional in nature. Just as the PRA has earlier resolved to suspend the numerical application of micro-prudential regulatory tenets, it is also time to consider if the accounting standard applicable to loan valuation inhibits flexibility by virtue of market-based assumptions that may not hold in post-pandemic conditions. The infusion of 'social' insights in relation to NPL management, especially SME and household loans, would also create qualitative points of reference that are consistent with a relational credit arrangement but not accommodated by a narrowly numerical accounting approach. We therefore argue that there is a case for flexible or suspended application of the market-based valuation standard for NPL management in these times.

We are concerned that leaving lenders to manage their tailored arrangements with borrowers as a matter of transactional adjustment, adhering to conservative prudential

<https://www.bankingsupervision.europa.eu/press/blog/2020/html/ssm.blog201204~c49fb771c6.en.html>.

¹⁵² For a similar argument from the perspective of corporate bonds, Plender J., 2020. The seeds of the next debt crisis, (Financial Times, 4 March 2020), from <https://www.ft.com/content/27cf0690-5c9d-11ea-b0ab-339c2307bcd4>.

¹⁵³ Numerically-framed regulatory governance often obscures imprecisions in achieving ultimately public-interest goals, as they create abstraction and disengagement with underlying governance issues, Sarfaty G.A., 2013. Regulating through Numbers: A Case Study of Corporate Sustainability Reporting. *Virginia Journal of International Law* 53 (3): 575.

compliance, would result in a predominantly ‘financial’ form of loan management, such as the sales of bad loans in securitised packages to investors, or financially-focused loan workouts. One need not be reminded of the risks of large-scale securitised sales that are opaque in character.¹⁵⁴ Specialist distressed debt firms also tend to take harsher approaches to debt collection than large lenders,¹⁵⁵ as they are not concerned with reputational effects to the same extent. Large-scale enforcement that is financially-motivated, can culminate in a social problem of financial oppression and severe negative effects on welfare.¹⁵⁶

We call for an integrated approach between the PRA and FCA in scrutinising the welfare effects of tailored arrangements for debtors. The joint supervision exercise is further relevant to the more important possibility that regulators may gain micro-level information that can allow them to form a picture of the aggregate levels of economic and social harm that need to be addressed.

5. Tailored Regulatory Supervision Beyond Tailored Debt Arrangements – A Roadmap for Scrutinising Financial Welfare Outcomes

In this section, we sketch out a blueprint for a combined FCA-PRA framework for overseeing the management of distressed SME and household debt. We argue that *tailored supervision*, in addition to tailored arrangements that regulators have imposed on banks to implement themselves, is necessary. We foresee tailored supervision to include regulatory guidance for debt arrangements, such as contractual adjustment¹⁵⁷ and larger scale bad debt management,¹⁵⁸ underpinned by combined regulatory objectives. At scale, however, regulators may be challenged in relation to the need to consider policies beyond their mandates, such as the reform of insolvency or bankruptcy laws,¹⁵⁹ large scale debt jubilee¹⁶⁰ or structural changes to debt products.¹⁶¹ Regulators’ roles in tailored supervision are nevertheless important as a first line of response to developing phenomena in debt management problems, and would also yield important information to inform meta-level policy discourses.

¹⁵⁴ Securitisation is one of the main manifestations of financialisation identified as a major cause of the 2007-09 global financial crisis, Hein E., Mundt M., 2013. Financialization, the Financial and Economic Crisis, and the Requirements and Potentials for Wage-led Recovery. In: *Wage-led Growth: An Equitable Strategy for Economic Recovery*, edited by Lavoie M., Stockhammer E., 154-155. London: Palgrave Macmillan.

¹⁵⁵ Gardner et al., n. 44, ch. 6.

¹⁵⁶ Mahmud, n. 59.

¹⁵⁷ Niinimäki J.P., 2014. Relationship Lending, Bank Competition and Financial Stability. *Czech Economic Review* 8 (3): 102.

¹⁵⁸ Enria A., 2020. ECB: the EU needs a regional ‘bad bank’ (Financial Times, 26 October 2020), <https://www.ft.com/content/cc3a9a51-4d9a-4c73-9ff0-9f623ecf4065>.

¹⁵⁹ Spooner, n. 13, chs 3-4.

¹⁶⁰ Mian and Sufi, n. 65; Turner, n. 24; Montgomerie, n. 13, p. 279-280.

¹⁶¹ See Mian and Sufi, n. 65, on equity risk-sharing mortgages.

We envisage that tailored supervision requires joint regulatory expertise to work with lenders on a per-asset basis, with inductive learning for groups of similar assets in due course. In such an exercise, regulators' joint expertise can be brought to the table to navigate potential conflicts of objectives, in relation to the prudential concern for NPL management and the concern for borrowers' treatment and welfare. Trade-offs between objectives are inevitably necessary to be considered, and the supervision on a per-asset basis will yield necessary ground-level information to support regulators' discussions and considerations in supervisory intervention.

There is scope at the supervisory level for regulators to guide debt interventions, in a manner beyond the general guidelines discussed for tailored mortgage arrangements in Section 3, for example. However, large-scale measures of debt restructuring such as write-offs would require further policy reform. It may be argued that regulators should have limited intervention powers into debt contracts, as this may entail uncertainty for contractual obligations and impede the future of private market outworking in the supply of credit. However, contractual re-writing and interventions are not unprecedented, and have been studied in analyses of the elasticity of law during extraordinary circumstances.¹⁶² On this view, it seems unwarranted to draw a line to allow certain constituents (such as sovereigns and large financial institutions) to benefit from legal elasticity and to disallow other segments of society from invoking that possibility.¹⁶³ Joint supervision also allows regulators to yield important ground-level information that connects to policy-making if issues of scale are discerned. Such a role does not overstep regulators' mandates but maximises the coordinative ethos that regulators already maintain to ensure that financial regulation objectives as a whole are met.

Second, it may be argued that tailored supervisions are impossible for regulators as being too resource-intensive, and regulators have over the years been inclined to prioritise resources according to risk-based principles.¹⁶⁴ This means that regulators would prioritise resources for regulatory issues of highest risk, and in this manner, household and small business debt may quantitatively not be viewed as posing significant systemic risk compared to the impact of large financial institutions and listed corporations. However, regulators should be reminded of the potential shortfalls of a strictly risk-based approach.¹⁶⁵ Distress for households and small business borrowers can become issues of social attention that

¹⁶² Pistor, n. 79; Reis M., Vasconcelos D., 2016. The Legal Theory of Finance and the Financial Instability Hypothesis: Convergences and Possible Integration. *Journal of Post Keynesian Economics* 39 (2): 206.

¹⁶³ Chiu I.H.Y., Kokkinis A., and Miglionico A., 2021. Debt Expansion as 'Relief and Rescue' at the Time of the Covid-19 Pandemic: Insights from the Legal Theory of Finance. *Indiana Journal of Global Legal Studies* 28 (1): 29.

¹⁶⁴ Black J., 2004. The Development of Risk-based Regulation in Financial Services: Canada, the UK and Australia - A Research Report (London: ECRC Centre for the Analysis of Risk and Regulation, LSE 2004), from <http://www.lse.ac.uk/collections/law/staff%20publications%20full%20text/black/risk%20based%20regulation%20in%20financial%20services.pdf>.

¹⁶⁵ Black J., 2012. When Risk-Based Regulation Aims Low: A Strategic Framework. *Regulation & Governance* 6 (2): 131.

regulators cannot ignore, and the aggregate impact of debtors' distress can have a deleterious effect on financial stability in the medium-term. We acknowledge that tailored supervisions are likely to constitute new demands for regulators, not to mention the need to establish a coordinating structure to carry this out. However, tailored supervisions can still be carried out with considered prioritisation, such as to debt restructurings likely to be complex, carry significant social consequences or have severe distributive consequences. We sketch out some guideposts below. Further, in undertaking these new roles, regulators should engage with a greater berth of multi-stakeholder accountability,¹⁶⁶ in order to mitigate the impression of unpredictable and discretionary actions and also to discourage moral hazard.¹⁶⁷

We propose that tailored supervision for tailored arrangements can be prioritised in situations where unsustainability and negative welfare are clearly apparent. These may involve borrowers whose income has reduced beyond a certain threshold since the onset of the pandemic for a sustained period of time.¹⁶⁸ For instance, for corporate borrowers this threshold could be set at 30-40% of revenues whereas for household borrowers at 20-25% of household income. The exact determination of the thresholds would require quantitative research on the impact of the pandemic and the correlation between income reductions and loan defaults. Other criteria that are important may be the social footprint of SME borrowers such as the extent of employee or supplier redundancy that may entail from their financial troubles. Banks should pro-actively identify these borrowers for flexible workouts, under tailored supervision from the FCA and PRA. The PRA and FCA can also engage in joint production of guidance to lenders where similar cases could benefit from similar treatment across the industry. In this manner, the PRA should be looking at using an extended form of Pillar 2 supervision in relation to supervising banks' financial positions and their risk management policies, tightly coupled with the FCA's input into appropriate customer treatment including a wide range of vulnerability factors and socially-significant factors. This coordinated approach that we argue for is consistent with an interpretation of the PRA's and FCA's broadly framed objectives that need to stand the test of time, and extends from their existing statutorily mandated coordination and cross-membership in their governing bodies.

In the longer-term, we argue that it would be advisable to amend conduct of business regulation to require lenders to collect richer and socially relevant information on individual and SME borrowers.¹⁶⁹ Such information would fill the current gap in data and permit lenders, in due course, to provide more tailored socially sensitive solutions to borrowers who have been affected by adversity. We also support the recent calls for facilitating a big data

¹⁶⁶ I.H.Y. Chiu, A. Kokkinis and A. Miglionico, n. 163.

¹⁶⁷ On the problem of moral hazard in the context of large systemically important banks, Schwarcz S.L., 2017. *Too Big to Fool: Moral Hazard, Bailouts, and Corporate Responsibility. Minnesota Law Review* 102: 761.

¹⁶⁸ Susskind D., Vines D., 2020. The economics of the COVID-19 pandemic: an assessment. *Oxford Review of Economic Policy* 36 (Suppl 1): S5.

¹⁶⁹ Current regulatory rules focus on information collection that is necessary for firms to assess the mental capacity and creditworthiness of prospective borrowers. FCA Handbook, CONC 2.10 and CONC 5.2.

infrastructure of borrowers¹⁷⁰ so that lenders can have better access to borrower information and provide choice for borrowers. Further empirical work in this area, to identify the types of socially material information that is not currently collected by lenders, as well as the construction of a data infrastructure that is compliant with data protection and security frameworks, are crucial to the future modernisation of distressed debt management.

Engaging in tailored supervision for tailored debt arrangements would allow regulators to recognise the financial needs of consumers and unsophisticated business borrowers, as well as to gather a rich array of information on the patterns and scale of debt management problems. Even if regulators' actions may not fully address the needs of SME and consumer borrowers, as distributive needs may need to be met by reforms beyond financial regulation, their roles in tailored joint supervision and information gathering would contribute to policy initiatives for sustainable debt management by society.¹⁷¹

Finally, we address the concern that our proposal for tailored supervision jointly by the PRA and FCA for banks' tailored debt arrangements would result in regulatory capture by the regulated lenders who seek assurance and, hence, a form of legal immunity in their actions. Banks are also in a position to lobby the regulators towards decisions that favour their private interests. We submit that tailored arrangements can be subject to *ex post* review or challenge, such as by the Ombudsman if the SME or individual concerned is of the view that the arrangement is unfair. We also propose that the general schema of tailored supervision, for example in relation to the selection of asset criteria that would be subjected to such supervision, can be made subject to public consultation so that stakeholders are able to feed input into the designs of the tailored supervision process. As observed by Omarova,¹⁷² engagement with stakeholders and civil society can provide a moderating influence upon the potential of capture in regulator-regulated relationships.

6. Conclusion

Bold regulator-led actions for short term debt relief and access to borrowing during the Covid-19 pandemic are likely to facilitate a significant level of post-pandemic indebtedness. As the

¹⁷⁰ FCA, 2020. FCA and Bank of England announce proposals for data reforms across the UK financial sector (7 January 2020), from <https://www.bankofengland.co.uk/news/2020/january/fca-and-boe-announce-proposals-for-data-reforms-across-the-uk-financial-sector>.

¹⁷¹ These are beyond the scope of the paper but include bailouts and bail-in proposals made by various commentators, including Eidenmüller and Valbuena, n. 141; van Zweiten K., Eidenmüller H., and Sussman O., 2020. Bail-outs and Bail-ins are better than Bankruptcy: A Comparative Assessment of Public Policy Responses to COVID-19 Distress, ECGI Law Working Paper No 535/2020, from https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3669541, as well as 'bad bank' provisions, Fleming S., Brunson J., 2020. EU banks urged to prepare for bad loans as pandemic hits economy (Financial Times, 11 November 2020), from <https://www.ft.com/content/3c6b4eb0-5b3d-4a37-87e5-d83da8de217d>.

¹⁷² Omarova S.T., 2012. Bankers, Bureaucrats, and Guardians: Toward Tripartism in Financial Services Regulation. *Journal of Corporation Law* 37 (3): 622, at 630-631.

prospects for economic recovery for different types of SME and household borrowers remain uncertain, excessive debt burdens can be welfare-depleting rather than wealth-enhancing in the long term. We argue that regulators, in exhorting the banking sector to manage debtors in ‘tailored arrangements’, seem to be taking an unwarranted back seat in leaving debt workouts to a transactional paradigm, after leading in financial welfare delivery during the pandemic. Regulators need to play a continuing role in such unprecedented times to safeguard financial welfare goals, which we argue enrich the FCA’s consumer protection objective, and give substantive meaning to the long-term financial stability goal that the PRA oversees. We argue that the PRA and FCA should establish a form of unprecedented but coordinated supervisory framework in ‘tailored supervision’ to oversee and guide banks’ tailored arrangements’ with their debtors. Although such supervision is resource-intensive and can entail risks in terms of moral hazard and regulatory capture, we suggest that in such coordinated supervision, the more socially-facing aspects of consumer protection can be enhanced and infused with the prudential aspects of distressed debt management, thus providing a more holistic basis for regulators to meet their objectives. Financial regulation extends beyond protecting the financial industry although the industry’s resilience is socially and economically important. Further, regulators’ joint supervision will yield important ground-level data that can help support the case for high-level policy changes where necessary, in relation to broader economic recovery and alleviation of debt-induced social harms and suffering. Although the broader problems of debt management by society are beyond the scope of this paper, this article contributes to this debate by highlighting the key roles financial regulators can play at the supervisory level for addressing immediate welfare and prudential issues, as well as information gathering for longer-term responses to deal with the aftermath of the pandemic. Post-pandemic debt management gives rise to unprecedented challenges, and it is timely for regulators to be more closely engaged with unfolding issues.