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Credit Protection Insurance: Too Good to Be True? Actual Challenges and Future Applications

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Credit Protection Insurance: Too Good to Be True? Actual Challenges and Future Applications

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Summary: 1. Drawbacks of Italian real securities. - 2. A new approach to credit risk management: credit protection insurance. - 3. Credit protection insurance in Italian loan industry: legal framework. - 4. Key issues of credit protection insurance: a) Self-interested lenders and coercion in purchasing insurance. - 4.1. b) APR voidness, usury and undue influence. - 4.2. c) Lack of transparency on restrictions and exclusions. - 4.3. d) Economic drawbacks. - 5. Conclusions.

1. Drawbacks of Italian real securities

The dismantling of barriers between financial markets, rising business risks, and abrupt economic shifts have exposed the shortcomings of real securities – such as *hypothèca* and *pignus* – under Italian law, which have proven inadequate in effectively safeguarding lenders in cases of borrower default.

Much has been written on the causes of the real securities' crisis.

For some, the most serious shortcoming of real securities lies in the excessive rigidity

and formalism the parties must comply with [01]. Creating valid and enforceable security interests over a segment of the debtor's property, such as a piece of land, a building, or a movable chattel, involves several formal steps, depending on the nature of the asset secured. *Hypotheca* regulation is an important example of this problem. In Italian law, *hypotheca* takes the form of a written deed containing a detailed description of the property and the credit secured, registered in the public registry of the judicial district in which the real estate is located. Furthermore, the renewal of the registration of the *hypothèca* must take place within the first twenty years of its registration in order to remain enforceable.

These formalities have proved particularly useful since they provide for the resolution of conflicts if there are multiple security interests or liens on specific collateral. However, there are downsides as well. Firstly, failure to comply with the requirements posed by the law prevents the lender from having a valid and enforceable security. Secondly, due to the above formalities, using collateral to secure a loan is costly and time-consuming, making it less attractive to lend or invest money where there is a significant risk that the borrower will not be able to repay the debt.

For other commentators the old-fashioned conventional real securities present an altogether negative cost-benefit picture due to critical issues related to foreclosure.

Despite the fact that real securities entitle the lender to seize the collateral if the borrower defaults on the agreed-upon payments, it is well known that, for the foreclosure to be effective, the collateral must be as liquid as possible. However, since the collateral is usually real estate property, it is unlikely for the lender to be able to recover the entire

01 See, *ex multis*, E. Gabrielli, *Studi sulle garanzie reali*, Torino, 2015, at 29 et seq.; G. Tucci, *Garanzia*, in *Dig. disc, priv*., sez. civ., Torino, 1992, at 579 et seq.; C. Licini, *Le tecniche moderne di garanzia nella prassi notarile*, in *Notar.*, 1996, at 1001 et seq.; V. Mariconda, *Trasferimenti commissori e principio di legalità*, in *Foro it*., 1990, I, at 1428; F. Realmonte, *Stipulazioni commissorie, vendita con patto di riscatto e distribuzione dei rischi*, in *Foro it.*, 1990, I, at 1440; M. Bussani, *Il modello italiano delle garanzie reali*, in *Contr. e impr*., 1, 1997, at 163 et seq.; G. Biscontini, *Assunzione di debito e garanzia del credito*, Napoli, 1993, pag. 16, which highlights the overly rigid formalism of real credit securities, inadequately suited to the features of a modern economy, increasingly integrated into global markets; A. Chianale, Ipoteca, in *Dig. IV, Disc. Priv., Sez. civ*., X, 1993, at 161; F. Fiorentini, *Garanzie reali atipiche*, in *Riv. dir. civ*., II, 2000, at 255 et seq. See also A. Veiga Copo, Función de la garantía real, Madrid, 2021, *passim*, at 7 et seq., noting that "*las clásicas figuras han perdido fuerza, tal vez la inercia y los parámetros configuradores hasta el presente de las mismas, las ha llevado a punto donde la estructura resiste, pero es onerosa, gravosa, poco funcional, documentalmente farragosa y no reporta tantos beneficios ni para garante ni para acreditante*". For a comprehensive analysis on the limits of possessory credit guarantees, see E. Gabrielli, *Il pegno "anomalo"*, Padova, 1990, at 94 et seq; Alb. Candian, *Le garanzie mobiliari. Modelli e problemi nella prospettiva europea*, Milano 2001, at 305 et seq.; G. Trovatore, *I nuovi confini delle garanzie reali mobiliari*, in M. Paradiso (a cura di), *I mobili confini dell'autonomia privata*, Milano, 2005, at 277 et seq.

credit in a timely manner [02]. As a result, real securities are widely perceived to be a slow and expensive way of achieving a credit coverage [03].

Making matters worse, the value of the collateral should be relatively stable for the entire duration of the obligation secured. As is known, the value of the asset used to secure a loan is one of the key aspects in lending practice. Lenders often use this value to estimate the level of risk associated with a particular loan application. Nevertheless, even if the collateral is typically required to be high value, liquid, and have a low depreciation rate, the lender is exposed to the risk that the value may decrease over the life of the loan anyway, especially in long-term financing.

In this scenario, the remedies for the lender are somewhat limited.

Where the collateral is secured against damages and it deteriorates or perishes because of events that that are outside the reasonable control of the borrower, article 2742 paragraph 1, Civil Code indicates two possibilities: the borrower may refund directly the lender secured, providing the indemnity paid by the insurance company; alternatively, he could use that indemnity to repair the property insured.-If the first solution is adopted, a form of improper real subrogation occurs – *pretium succedit in locum rei*. Instead, where the borrower uses the indemnities to restore the damaged property, a real subrogation occurs – *res succedit in locum rei* –. Whichever solution the borrower chooses, if the collateral is insured against damages, the law provides some form of protection for the lender in case of deterioration or impairment.

By contrast, where the borrower has not stipulated insurance against damages, such right of subrogation cannot operate. According to Article 2743 Civil Code, if the value of the collateral becomes unsatisfactory [04] the lender can solely demand another suitable guarantee on another asset or, alternatively, invoke its right to demand the immediate payment of all the outstanding loan before the standard terms of the loan expire [05].

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02 See F. Fiorentini, *Garanzie reali atipiche*, cit., at 257.

03 See. E. Gabrielli, *Studi sulle garanzie reali*, cit., at 29.

04 Article 2743 Civil Code does not define the meaning of insufficient value, and it is substantially untested in the courts. As one commentator has pointed out, the value of the security may be considered insufficient when, according to article 2875 Civil Code, the collateral has a value lower than the amount of the credit and the accessories, increased by one third. See V. Andrioli, *Conservazione della garanzia patrimoniale. Divieto del patto commissorio. Privilegi*, in *Comm. Cod. Civ.*, a cura di A. Scialoja e G. Branca, Libro sesto, Tutela dei diritti, art. 2740-2899, Bologna-Roma, 1960, at 47. Vice versa, other commentators stated that the parameter offered by article 2875 Civil Code is only indicative. See V. Roppo, *La responsabilità patrimoniale del debitore*, in *Tratt. Rescigno*, XIX, 2, Torino, 1997, 2ª ed., at 556.

05 Instead, when the borrower causes a decrease in the value of the collateral, he loses any term of performance envisaged in his favor, and the lender can accelerate repayment of the loan, as stated by article 1186 Civil Code.

Despite article 2743 c.c. *prima facie* providing appropriate protection, this provision actually serves little to no purpose. The problems can be simply stated in the following way.

First of all, in most cases the borrower owns only one property eligible to secure the repayment of the loan.

Furthermore, the prevailing doctrine pointed out that article 2743 Civil Code does not apply if the value of the collateral is depreciated due to a general economic decline, such as a significant fall in the housing market. Indeed, the lender, by accepting a security interest over real estate asset, takes the risk that a significant decline in general economic activity may negatively impact the Loan-to Value-Ratio (LTV) and, moreover, that the value of the collateral which secures the repayment may become unsatisfactory [06].

In light of this evidence, it is not surprising that, where the value of the asset pledged by a borrower drops, the lender's ability to collect the outstanding debt is appreciably reduced. Making matters worse, such situation may indirectly strengthen the borrower's position. Indeed, it is an established fact that the risk of foreclosure is a strong incentive for the borrower to perform the obligation, otherwise he loses his collateral. However, when the value of the collateral is seriously decreased over the life of the loan, the lender may find it hard to seize the asset and obtain the whole value of the loan. Accordingly, the borrower may be induced to default, trusting that the lender will not take legal action against the property secured.

One last point can be made before we turn to the next subject. The shortcomings of the real securities affect not only the lender's ability to recover the outstanding debt, but also have significant economic drawbacks. On the one hand, the uncertain credit protection offered by old-fashioned real securities discourages the inflow of foreign capitals that are looking for an efficient legal system with minimal intricacy; on the other hand, the lack of mechanisms able to effectively reduce the lender's credit risk may also increase the interest rate paid by the borrower on its debts. In fact, the higher the risk, the higher will be the interest rate charged for borrowing, since the lender deals with a greater chance that, in the event of default, the security granted by the borrower will not allow him to recover the outstanding debt.

2. A new approach to credit risk management: credit protection insurance

As noted, serious issues have been discovered in the old-fashioned real securities. Accordingly, it comes as no surprise that the Italian loan industry has forced to adopt new

06 See V. Andrioli, *Conservazione della garanzia patrimoniale. Divieto del patto commissorio. Privilegi*, cit., at 50.

contractual mechanisms to better guarantee the repayment of a loan. Among many options, when there is a significant risk that future circumstances may lead the borrower to default on the agreed-upon payments, lenders frequently require the borrowers to take out an insurance policy against the risk of default, referred to as credit protection insurance (CPI) or payment protection insurance (PPI).

Credit protection insurance is exactly what the name implies.

Rooted in common law systems, credit protection insurance is a low-cost/high-value agreement designed to make debt payments on the borrower's behalf in the event of death, disability, involuntary unemployment, critical illness, or other circumstances that may prevent the borrower from earning income to service the debt [07].

Credit protection insurance is a three-party arrangement involving an insurance company, a lender – typically a banking institution – and a borrower. The insurance company, upon the payment of a premium usually paid in a lump sum at the time of signing the loan, is legally bound to reimburse, totally or partially, the borrower's debt when an event that make the borrower temporarily or definitively unable to meet the economic commitments undertaken occurs [08].

Depending on whether the inability to pay the debt is temporary or permanent, the insurance company pays the lender, respectively, part or all of the outstanding debt.

The adoption of such relatively plain vanilla insurance policies provides key advantages for the borrower, the borrower's heirs and the lender. From the borrower's standpoint, it offers hefty and affordable protection, it is easy to obtain and does not require the borrower to grant a real security over a segment of their property to guarantee the full payment of the debt. On this view, credit protection insurance prevents many homeowners

07 Credit protection insurance provides coverage for various debt obligations, including mortgages, consumer loans, and credit cards. However, in the Italian context, a range from 70 to 80% of credit protection insurance secures personal loans. See A. Lovera, *Le trappole della polizza sul mutuo: costi elevati e regole non sempre applicate*. https://argomenti.ilsole24ore.com. It should be noted that, in the U.S., credit protection insurances offer short-term protection – typically from 12-24 months (STIP) – while in the Italian loan industry such policies usually secure long-term loans.

08 Debt protection products, known as debt cancellation contracts or debt suspension agreements, suspend or cancel all or part of a consumer's obligation to repay an outstanding credit card balance when a qualifying event occurs, such as death, disability, or involuntary unemployment. The issuer charges fees for the debt protection product, typically on a monthly basis. However, debt protection is a banking product structured as two-party arrangements, directly sold by credit card issuers to consumers who hold a credit card with them, while credit protection insurance is a three-party arrangement that involves an insurance company. On the differences between credit insurance and debt protection products, *see* United States Government Accountability Office. Report to Congressional Committees. Consumer Costs for Debt Protection Products Can Be Substantial Relative to Benefits but Are Not a Focus of Regulatory Oversight, 2011, at 4 et seq. https://www.gao.gov/assets/gao-11-311.pdf.

from getting into the situation that is now producing so many foreclosures. From the standpoint of the borrower's heirs, it ensures that, in the event of death, the borrower's assets will be clear and free, and they can accept the inheritance without repaying the outstanding debt. Finally, from the lender's standpoint, credit protection insurance is an important device for at least four reasons. First: it provides adequate protection if the borrower does not make the agreed-upon payments. Second: because the insurance company is legally bound to reimburse, totally or partially, the debt on behalf of the defaulted borrower, the loan will not be considered non-performing (NPL) [09]. Accordingly, the lender does not generate losses nor has to put aside money to cover the losses he expects to incur. Third: credit protection insurance is a low cost/high value agreement, because the lender does not need to apply to a court to try to recover the outstanding debt. Fourth: when lender directly sells the add-on credit insurance to the borrower, the commission paid by the latter offers to the former an additional earning.

3. Credit protection insurance in Italian loan industry: legal framework

In the Italian context, there are diverse regulatory measures aimed at regulating the phenomenon of credit insurance connected to loans [10].

As Primary Law, the Legislative Decree 68/2018 implements the provisions of Article 24 of Directive (EU) 2016/97 (Insurance Distribution Directive - IDD) of January 20, 2016. This Directive is aimed at minimum harmonization and should therefore not preclude Member States from maintaining or introducing more stringent provisions in order to protect customers, provided that such provisions are consistent with Union law, including this Directive.

The Private Insurance Code (Legislative Decree No. 209 of September 7, 2005), in Article 120-*quinquies*, paragraph 5, provides that IVASS, with reference to insurance distribution activities, may apply the precautionary and prohibitory measures provided for.

09 Even though there is no standard definition of non-performing loans (NPL) in place, NPL is usually defined as a loan in which the borrower is in default or close to default because they have not made the scheduled payments for a specific period. Specifically, commercial loans are considered NPL in banking practice where the debtor has made zero payment of interest or principal within 90 days. For NPL definition and criteria for non-performing loan classification, see *ex multis* Eighteenth Meeting of the IMF Committee on Balance of Payments Statistics Washington, D.C., June 27–July 1, 2005. The Treatment of Nonperforming Loans, 2005. https://www.imf.org, accessed June 2024; European Central Bank Guidance to banks on non-performing loans, 2017. https://www.imf.org/external/pubs/ft/bop/2005/05-29.pdf.

10 For an overview of the regulatory framework in place see: Credit Protection Insurance (CPI) Sold Via Banks, EIOPA, 2022, at 99 et seq. https://www.eiopa.europa.eu/system/files/2022-09/eiopa-thematic-review-on-credit-protection-insurance2022.pdf. For further considerations, see V. Carriero, *Le valutazioni dell'EIOPA sulle polizze assicurative del credito (CPI)*, in *Banca Borsa tit. credito*, 2023, at 906 et seq. Recently, on the regulatory measures concerning credit protection insurance, D. Roselli, *Polizze connesse a finanziamenti e indici di abbinamento*, https://www.dirittobancario.it/art/polizze-connesse-a-finanziamenti-e-indici-di-abbinamento/.

Among the measures, it is worth noting that IVASS has the power to prohibit the sale of insurance along with a service or product other than insurance, when such practice is harmful to consumers. The adoption of such measures by IVASS, in any case, does not affect the power of the Competition and Market Authority (AGCM) to sanction unfair commercial practices [11].

In addition to the above, as Secondary Law, the paragraph 2, section XI, of the Bank of Italy Provision of July 29, 2009 – aimed at regulating the transparency of banking and financial transactions and services – clarifies that in the event of the simultaneous offer of loans and other contracts of a different nature that would create complexity, particular precautions must be taken to mitigate and manage legal and reputational risks.

Article 59-*bis* of IVASS Regulation 40/2018, an article added by Article 4, paragraph 22, of IVASS Provision No. 97/2020, requires distributors offering insurance products together with a product or service other than insurance to provide the policyholder with an adequate description of the various components of the agreement or package and separate evidence of the costs and charges of each component, as well as how its composition modifies the risks or insurance coverage. Furthermore, in the case of distribution with advice of an insurance product as part of a package or the same agreement, distributors ensure that the entire package or agreement is suitable for the customer's needs

The IVASS-Bank of Italy letter of March 17, 2020, states, among other things, that (i) the offer of non-financial products in conjunction with a loan requires the adoption of several precautions to ensure compliance with the relevant regulations and preserve the integrity of the trust relationship with customers; (ii) it is necessary that the behaviors actually implemented ensure the correctness of the relationships and the customers' effective awareness of the characteristics, obligations, and advantages deriving from the combination of the products offered; (iii) it is important to identify and manage with particular attention, adopting appropriate safeguards and adequate measures, situations of conflict of interest related to participatory or commercial agreements between the promoter of the insurance policy and the loan provider or distributor (even in the case of agents/brokers); (iv) non-compliance, both formal and substantive, with the current rules, in addition to resulting in the application of the sanctions and remedial measures provided for the violation of conduct obligations towards customers, may expose operators to significant legal and reputational risks, with the potential possibility of an increase in capital requirements by the competent supervisory authorities; (v) banks, financial intermediaries, and insurance companies are required to adopt and

11 Cfr. Tar Roma, n. 4295/2019 which has confirmed AGCM's sanctioning competence for unfair commercial practices in the insurance sector, as the Insurance Code does not provide specific regulations regarding consumer protection.

implement organizational and internal control procedures that allow for a continuous assessment of the risks (including legal and reputational) associated with the simultaneous or combined offer of multiple contracts; (vi) the combination of loans and insurance policies must comply with banking and insurance regulations and the rules on unfair commercial practices in consumer relations; (vii) periodic checks on the combination indices of the products offered are necessary, articulated at different levels of detail and aimed at examining the different indicators at the territorial level, by type of distribution channel, and by individual distributor, in order to intercept potential anomalous behaviors in the marketing of the products.

4. Key issues of credit protection insurance: a) Self-interested lenders and coercion in purchasing insurance

Credit protection insurance, when adequately developed and targeted, can be useful for both consumers and lenders. Bearing this in mind, the recent spread of these devices in the Italian context – and the growing number of litigations – highlights a number of issues that significantly reduce their efficiency and effectiveness [12].

The major problem is the strong interest of the lender in having the borrower take out such insurance. The reasons for this are intuitive: on the one hand, credit protection insurance enables the lender to transfer the default risk cost-free to a third-party guarantor; on the other hand, the distribution of credit protection insurance can generate additional non-interest income for banks [13].

These circumstances have raised concerns that the lender could coerce the borrower into taking out such insurance. Indeed, although the insurance is formally intended as an optional purchase and even if the consumer has the right to choose their own insurance provider – provided that their insurance policy offers an equivalent level of guar-

12 For a comprehensive review of the critical issues of the Payment Protection Insurance, see *IVASS – Banca d'Italia, Polizze abbinate a finanziamenti (PPI - Payment Protection Insurance). Misure a tutela dei clienti*; Credit Protection Insurance (CPI) Sold Via Banks, EIOPA, 2022, 28 ss. https://www.eiopa.europa.eu/system/files/2022-09/eiopa-thematic-review-on-credit-protection-insurance2022.pdf.

13 This issue is also accentuated by the fact that, as part of the *bancassurance* business models for the manufacturing and distribution of CPI products, banks are frequently in close partnership with insurers. On this point, Article 21, par. 3-*bis* of Consumer Code (Legislative Decree no. 206 of 6 September 2005), introduced by Article 36-*bis*, par. 1, Decree Law no. 201 of 6 December 2011, converted into Law no. 214 of 22 December 2011, introduced the following rule: "it is considered to be an unfair commercial practice when a bank, credit institution or financial agency makes the stipulation of a loan contract conditional on the stipulation of an insurance policy supplied by the same bank, institution or intermediary or to open an account with the same bank, institution or intermediary".

antee as the insurance policy offered by the creditor [14] – in most cases, the conclusion of such an insurance contract is compulsory to obtain the credit or to obtain it on the marketed terms and conditions.

On this point, The Italian Banking and Financial Ombudsman (ABF)[15] has observed that the formal nature of the credit-related insurance, specifically qualified as optional in the contract, is not enough to exclude the implied compulsory nature of the said policy. According to the ABF and IVASS-Bank of Italy[16], the formal qualification of the contract alone is not sufficient to assert that the borrower is truly free to take out such an insurance product. Instead, the investigation must be carried out by evaluating systematic indices to genuinely determine whether or not the signing of the insurance contract

14 See Article 135, Law no. 124 of 4 August 2017, amending Article 28 Decree Law no. 1 of 24 January 2012, converted into Law no. 27 of 24 March 2012, n. 27, which states that where banks, credit institutions and financial intermediaries make the granting of a real estate loan or of consumer credit conditional on the conclusion of an insurance contract, or where the proposal of an insurance contract is linked or ancillary to the granting of the loan or credit, they shall be required to accept the policy that the customer has chosen from the market without changing the conditions offered for the granting of the real estate loan or consumer credit; if it is necessary to obtain the loan or to obtain it at the conditions offered, the policy submitted by the customer must meet the minimum requirements established by the bank, credit institution and financial intermediary. See also 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 (amending directives 2008/48/EC and 2013/36/EU and regulation (EU) No 1093/2010) which states that "(…) while it is justified for creditors to be able to require the consumer to have a relevant insurance policy in order to guarantee repayment of the credit or insure the value of the security, the consumer should have the opportunity to choose his own insurance provider, provided that his insurance policy has an equivalent level of guarantee as the insurance policy proposed or offered by the creditor. (…)".

Furthermore, the Supreme Court, no. 2989 of 1st February 2022, has stated that Article 28 of Law Decree 1/2012 and Article 1, par. 1 of Isvap Regulation no. 40/2012 also applies to insurance contracts "connected" or "conditional" on a loan contract, i.e., policies whose stipulation was demanded or imposed by the lender, regardless of the inclusion in the loan contract of formal clauses making their validity or effectiveness conditional on the stipulation of the insurance contract. Therefore, the insurance contract, not compliant with the predefined model issued by sectorial authority, is considered void and the differing clauses must be automatically substituted. For a more in-depth analysis of the ruling, see A. Camedda, *L'"abbinamento" di polizze assicurative ai contratti di credito: il sottile confine tra facoltà ed obbligo*, in *Resp. civ. prev.*, 2022, 3, pag. 781 et seq.

15 ABF is an alternative dispute resolution scheme for disputes between customers, banks, and other financial intermediaries concerning banking and financial transactions and services.

16 IVASS supervises over transparency and fairness in the behavior of undertakings, intermediaries, and other insurance market participants concerning stability, efficiency, competitiveness, and the smooth operation of the insurance system, to the protection of policyholders and of those entitled to insurance benefits as well as to consumer information and protection under the Code of private insurance. The Bank of Italy supervises compliance with the rules and principles of transparency and fairness in the relations with clients under the provisions of Title VI of the Consolidated banking law (legislative decree no. 385 of 1 September 1993).

was de facto an essential requirement for obtaining the loan on agreed terms [17].

This view is supported by many recent ABF decisions, which have held that the borrower, who bears the burden of proof, may produce evidence to establish that, despite being qualified as an optional purchase, the conclusion of such an insurance contract is compulsory to obtain the credit or to obtain it on the marketed terms and conditions. Notably, as it has been judicially pointed out [18], the borrower has to demonstrate at least one of the following circumstances:

- that the policy serves the function of covering the credit;
- that there is a genetic and functional connection between the loan and the insurance, which can be deduced from the fact that the two contracts were stipulated at the same time and have the same duration;
- that the indemnity agreed upon has been parameterized to the residual debt.

To counter these presumptions, the lender must instead demonstrate alternatively that:

- it has proposed to the borrower a comparison of costs, from which it emerges that the lender has offered the loan on the same financing conditions, aside from insurance;
- it has offered similar conditions, without the stipulation of the policy, to other parties with the same creditworthiness;
- it has granted the borrower the right to rescind from the insurance contract, at no cost and with no effect on the total cost of the loan.

4.1. b) APR voidness, usury and undue influence

The problem identified in the previous paragraph – whether the purchase of the credit protection insurance is an optional or compulsory purchase – might be considered conjectural but is relevant for at least three reasons.

First of all, when factual elements suggest that the subscription of the insurance was

17 See ABF, Naples 2021, n. 2046. https://www.arbitrobancariofinanziario.it/decisioni/2021/01/Dec-20210126-2046.PDF. This reading is also confirmed by IVASS-Bank of Italy, illustrated in the joint letter of 26 August 2015. https://www.ivass.it/consumatori/azioni-tutela/lettere-mercato/documenti/PPI_Misure_a_tutela_dei_clienti_ENG.pdf.

18 See ABF, Collegio di Milano, December 13, 2018, at 4. http://www.ilcaso.it/giurisprudenza/archivio/21586.pdf. See also Cass. April 5, 2017, n. 8806. http://www.ilcaso.it/giurisprudenza/archivio/17082.pdf. The court held that insurance expenses are relevant to the finding of usury if the borrower demonstrates the connection between such expenditure and the loan. Such connection is presumed where there is contextuality between the expenditure and the disbursement.

intended by the lender to be implicitly compulsory, the premium paid by the policyholder needs to be charged in the Annual Percentage Rate of Charge (APR) [19], as stated by article 121 Legislative Decree no. 385, September 1, 1993 (TUB) as amended [20].

In such an instance, if the borrower proves that the cost of the credit protection insurance was illegitimately not included in the total amount of the APR because the insurance was not truly optional but rather compulsory to obtain the loan:

a) according to article 125-*bis*, paragraph 6, TUB, the APR clause is deemed void;

b) according to article 125-*bis*, paragraph 7, TUB – following article 125-*bis* paragraph 6 TUB - once the APR clause is deemed void as specified under a), the amount of the APR is determined *ex lege* according to the value of the minimum nominal rate of treasury bonds or similar bonds indicated by the Ministry of Economy and Finance, issued in the twelve months prior to the conclusion of the contract. Moreover, no other sum is due from the consumer by interest rates, commissions, or other expenses [21].

c) due to the effect and application of the well-known general civil law principle *quod nullum est, nullum producit effectum*, according to article 2033 Civil Code the borrower has the right to take action to recover undue payments.

Secondly, it raises a question of whether the interest rate applied by the bank, charged by the total cost of the credit insurance, exceeds the applicable usury threshold, since the insurance premium is charged *a posteriori* to the APR. As a matter of fact, where the APR rate applied is higher than the rate permitted by law, under article 1815 paragraph 2 Civil Code the contractual clause referred to interest is void, while the loan contract is valid in all other aspects, in homage to the principle of *favor debitoris* [22].

Thirdly, determining whether the purchase of the credit protection insurance is an optional or compulsory purchase is relevant even if the cost of the policy is calculated *ex ante* in the total amount of the APR. Indeed, in all cases where credit protection insurance is a condicio sine qua non for obtaining the loan, it is required to verify if the borrower's consent to take out the policy was freely given or vitiated by the lender's

19 APR is not the same as the interest rate. While the latter is the annual cost of a loan to a borrower, the former refers to the annual cost of a loan to a borrower, including other charges or fees such as credit insurance, most closing costs, discount points, and loan origination fees. Thus, APR gives the borrower more information about the loan's actual cost.

20 This view has some support in ABF Rome 2015, decision n. 8128. https://www.arbitrobancariofinanziario.it/decisioni/2015/10/Dec-20151022-8128.PDF.

21 ABF 2016 Collegio di coordinamento, decision n. 1430 https://www.arbitrobancariofinanziario.it/decisioni/2016/02/Dec-20160218-1430.PDF.

22 See, ABF, Coll. Coord. 2018, decision n. 12830. https://www.arbitrobancariofinanziario.it/decisioni/2018/06/Dec-20180608-12830.PDF.

illegitimate pressure. The issue is relevant, since a party claiming to be the victim of illegitimate pressure may be able to void the terms of the contract.

Italian commentators do not seem to have dealt with this question. At any rate, at first blush it may be difficult to bring such pressure within the definition of violence posed by article 1435 Civil Code.

The Italian Civil Code embraces a very limited concept of contractual violence, which formally operates as a vitiating factor in relation to the contract only in the case of a threat that intimidates a sensible person and makes the person afraid to expose themselves or their assets to an unjust and significant damage.

However, in this case, it is not a threat but rather illegitimate psychological pressure on the borrower. Indeed, the lender is in a position of power over the borrower for several reasons, namely an elevated status, higher education, and an emotional tie, especially when the borrower is in a critical financial situation. Due to the unbalanced relationship between the two parties, the lender is able to coerce the borrower into making decisions that might not be in his best interest without any threat, only by relying on his position of power over in order to achieve their desired outcome.

This coercion, which in any case is outside the spirit and wording of Article 1435 of the Civil Code, may instead fall under the doctrine of undue influence in common law systems and make the contract voidable, even though the transaction, in commercial terms, provides reasonably equal benefits for both parties.

4.2. c) Lack of transparency on restrictions and exclusions

Credit protection insurances often contain various kinds of exclusions, depending on the type of loan secured, that significantly reduce the coverage of the policy [23]. For example, insurance coverage is commonly excluded in case of hospitalization where the policyholder has a preexisting health conditions or disabilities, or in case of unemployment, when the borrower is employed part-time or seasonally.

Despite the fact that restrictions and exclusions are an essential feature of credit protection insurance, most banks sell such insurance without providing adequate disclosure about the coverage and the exclusions [24]. The omission of key information in selling credit protection insurance, that qualifies, under applicable laws, as *misleading*

23 See IVASS, Policies linked to loans (PPI - Payment Protection Insurance). Measures protecting customers, classification III 2 6, at 3 et seq. https://www.bancaditalia.it.

24 Clear evidence of this can be seen when considering the indications provided by the Financial Ombudsman Service (FOS), which, in listing the most common complaints about mis-sold PPI, indicates, among others, the lack of awareness about things the policy did not cover.

information, can pose considerable problems [25].

For example, misselling may lead the borrower to take out credit insurance policies overpriced than needed for their personal needs. Misselling may also distort consumers' choice and could result in them purchasing insurance products that fail to provide the cover they need or even that are not necessary. Lastly, this practice makes it more difficult for consumers to compare products and make informed purchasing decisions.

In addition to conflicting with the duty to act in accordance with the best interests of the consumer, misselling has a long-term negative impact on the overall relationship between lender and borrower, reducing levels of cooperation and discouraging appropriate repayment of the debt.

4.3. d) Economic drawbacks

Although credit protection insurance *prima facie* has a positive effect on the financial system, playing a key role in facilitating access to credit and supporting economic growth consistent with solid protection of borrowers, there are reasons to believe that widespread reliance on these policies can have far-reaching negative consequences on the economy as a whole. The most relevant factor when assessing the systemic impact of credit protection insurance in the financial industry is the main function of such devices. Indeed, these insurances are not meant to minimize the adverse effects caused by default of the loan, but rather transfer only the risk of default to a third-party guarantor, namely the insurer. Accordingly, excessive reliance on these policies may encourage the spread of *moral hazard* [26], such as refraining from conducting in-depth credit evaluation of the creditworthiness and solvency of the prospective borrower.

In this view, it is easy to see that an upward trend in using credit protection insurance to back financial transactions can trigger a negative vicious cycle, wreaking havoc on the financial system as a whole. In fact, the more inadequately secured debt positions

25 According to Article 6, 1 (e) of the Directive 2005/29/EC: "A commercial practice shall be regarded as misleading if it contains false information and is therefore untruthful or in any way, including overall presentation, deceives or is likely to deceive the average consumer, even if the information is factually correct (...)".

26 *Moral hazard* is a concept coined in the insurance industry during the nineteenth century, parallel to the large-scale introduction of private insurance and social security systems. *Moral hazard* is typically defined as the risk, common in the lending and insurance industries, that a party has not entered into a transaction in good faith or has provided misleading information about its assets, liabilities, or credit capacity. On *moral hazard* see, among many, M.V. Pauly, The Economics of Moral Hazard: Comment, in The American Economic Review 58, no. 3 (1968), at 531–37; J.M. Marshall, Moral Hazard, in The American Economic Review 66, no. 5 (1976), at 880–90; J.F. Zendejas,, N. Gaillard, R.J. Michalek, (Edited by), Moral Hazard: A Financial, Legal, and Economic Perspective, London, 2022.

there are, the greater the risk that, in the event of a significant economic contraction, widespread insolvency could put excessive pressure on insurance institutions, creating an immediate obligation to pay millions or billions owed to the lenders.

Simultaneously, this circumstance may require massive government bailouts expressly to avoid systemic problems for the broader economy.

This risk is not speculative but real and troubling, considering the similarity between credit protection insurance and another insurance against non-payment, popular in the early 2000s, known as credit default swaps (CDS), a major player in the 2008 U.S. subprime mortgages collapse.

5. Conclusions

As stated, there are numerous critical issues related to credit protection insurance. First, the legal landscape that governs credit protection insurance has led to a growing number of disputes which, to put it mildly, have severely restricted the utility of such policies. Second, unrestrained reliance on credit protection insurance may jeopardize economy stability, exacerbating systemic risk and severely shaking confidence in the financial system. Third, providing misleading information on the process of sale can have a long-term negative impact on the overall relationship between lender and borrower, reducing levels of cooperation and impeding appropriate action regarding the repayment of the debt.

Notwithstanding these issues, we will argue that we should not throw the baby out with the bathwater. In fact, it seems that the recent proliferation of litigation involving credit protection insurance stems primarily in regulatory failure rather than in the device itself.

Based on the evidence collected, it can be said that the complex regulatory framework in place, as implemented with the provisions of the Directive (EU) no. 2016/97 (Insurance Distribution Directive - IDD) contained in Legislative Decree no. 68/2018, still does not appear adequate to prevent the significant risks for consumer arising from poor underwriting, sales practices and insufficient management of conflicts of interest arising in the context of bancassurance sales.

In light of this, we firmly believe that a comprehensive reform of the legal framework surrounding credit protection insurances might fix all the above-mentioned critical issues. In fact, it can be said that an improved and tighter regulation – that exhaustively determines terms and conditions of such policies, disclosure rules, issuance limits, fees charged, and sanctions for unfair or deceptive market practices – could help to reduce the likelihood of misselling, to restrain financial institutions from charging excessively high fees and also to prevent potentially destabilizing effect on economy.

In addition, it is reasonable to assume that a comprehensive regulation may unleash the full potential of such devices, far beyond what has been explored so far.

For example, it is easy to see the appeal of such policies in order to mitigate credit risk related to short-term financing offers by BNPL (Buy Now Pay Later) suppliers. As known, a growing number of people opt to use BNPL services to shop online by splitting the cost of the purchase into multiple installments instead of making one full payment upfront. This is made possible by the fact that, a bank, or other financial intermediary, advances the entire amount to the seller and receives a commission from the seller in exchange for the service.

This new flexible option to pay has numerous advantages: from the consumers standpoint, they can buy higher quality products they previously could not afford, usually without interest or fees [27]; from the merchant point of view, they see a robust growth in sales, an increase in average order value and a greater exposure online.

At the same time, it must also be noted that the development of BNPL services, and the increased accessibility to loan provided by digital channels, have also highlighted several issues [28]. First of all, the easier access to credit can influence consumers to enter into credit agreements without being fully aware of the services requested and the risks associated with them. This concern has also been pointed out by the European Banking Authority (EBA), which considers there to be a concrete risk that consumers might access innovative forms of financing without a prior and thorough evaluation of their own creditworthiness [29].

It should also be considered that BNPL services lower consumers' awareness of the contractual and financial commitments they undertake, encouraging impulse buying

27 These loans, often interest-free, differ from a traditional credit card purchase which charges interest every month unless the balance is paid in full each month. In addition to interest-free pay-in-four loans, recent Consumer Reports show that some BNPL suppliers also offer other kinds of loans, with longer terms (for example, 6-12 monthly payments or more) and interest rates, making certain BNPL loans more expensive than credit card financing. See, L.L. Gill, New Buy Now, Pay Later Loans Come With More Risks, https://www.consumerreports.org/short-term-lending/new-buy-now-pay-later-loans-come-with-more-risks-a1161982784/.

28 The European Commission has intervened with the aim of strengthening protections for users of BNPL, specifically including this service within the scope of application of the Directive (EU) 2023/2225 (CCD II). For an analysis of the main aspects considered by Directive (EU) 2023/2225 see B. Losacco, *Le insidie del* Buy Now Pay Later *e la tutela dei consumatori vulnerabili*, July 11, 2024, https://www.dirittobancario.it/art/le-insidie-del-buy-now-pay-later-e-la-tutela-dei-consumatori-vulnerabili.

29 EBA, *Consumer Trends Report 2022/2023*, 24 april 2023, at 137 *https://www.eba.europa.eu/sites/default/files/document_library/Publications/Reports/2023/1054879/Consumer%20Trends%20Report%202022-2023.pdf.*

and revealing previously ignored conditions of vulnerability [30].

Little is known about the BNPL's credit risk policy. However, it seems that many BNPL suppliers usually do not take specific guarantees to secure the payment nor conduct in-depth credit evaluation about creditworthiness. By contrast, such companies making short-term financing on an unsecured basis, often rely on late fees, accrued interest and credit score dings.

It must be noted that these remedies only provide little relief for BNPL suppliers when buyers miss the payment due. In fact, it is widely recognized that the failure to meet debt installments is primarily due to a debtor's critical financial situation. Accordingly, it is unlikely that the defaulted debtor will be able to fulfill the greater sum due as an additional interest. Thus, BNPL suppliers will frequently discover that they are only able to recover a small fraction of the debts owing to them by the defaulted debtor.

By contrast, a credit protection insurance may mitigate BNPL suppliers' exposure to the debtor's insolvency. In fact, when a cause of default provided for in the credit protection insurance agreement occurs, the repayment of the outstanding debt is made by the insurance company [31].

BNPL suppliers will of course need to be careful in drafting the credit protection insurance, defining scrupulously the list of events whose occurrence totally or partially compromises the buyer's ability to meet the debt.

In a broader perspective, credit protection insurance may also be an alternative solution to secure a husband's debts where the only asset suitable to secure the repayment is the matrimonial homes jointly owned by the spouses. As is known, in recent times matrimonial homes have become a leading source of loan security. Providing such security, when the homes are in the joint names of the spouses, requires the consent of both. Despite society's recognition of gender equality and the firm rejection of the concept that the wife is subservient to the husband in the management of family finances, many wives are still subjected to undue influence by their husbands. Consequently, wives often become responsible for their partner's financial debts after being convinced or misled into allowing charges over jointly owned matrimonial homes. As a

30 Cfr. S. Digregorio, F.M. Gabbricci, *L'innovazione tecnologica ed il consumatore in ambito bancario*, in *Il consumatore vulnerabile tra innovazione e diritti fondamentali – Consumerism 2022, Consumers Forum*, dicembre 2022, at 11 *https://www.consumersforum.it/iniziative/2022/5112-il-consumatore-vulnerabile-tra-innovazione-e-diritti-fondamentali.html.* Per più ampie considerazioni sulle vulnerabilità dei fruitori di BNPL, see B. Losacco, *Le insidie del* Buy Now Pay Later *e la tutela dei consumatori vulnerabili*, cit.

31 It's worth noting that some insurance companies have recently started to offer insurance products compatible with BNPL services, designed to protect the seller in the event of non-payment by the buyer.

result, when husbands fail to repay the debt, wives are often exposed to the negative consequences of foreclosure.

This unethical and detrimental phenomenon, labeled as Sexually Transmitted Debt (STD) [32], which does not currently assume relevance in the Italian legal context but is widely documented in English and Australian jurisprudence, is particularly important in the modern loan industry. In fact, when it is demonstrated that the wife has been induced to enter into a transaction by the undue influence of the husband, the former is entitled to set that transaction aside [33]. Such reason makes vulnerable loans granted on the security of matrimonial homes, and banks will be unwilling to accept such security, thereby reducing the flow of loan capital [34].

On this view, credit protection insurances seem suitable for mitigating the negative effects of Sexually Transmitted Debt, by providing benefits to all the contracting parties. In fact, with these policies the lender is guaranteed in case of default, even without obtaining the matrimonial home as a collateral. Additionally, because the risk of the husband's default is borne by the insurance company – at least when default is caused by an event covered by the insurance – wives are free from liabilities, avoiding the trauma of losing matrimonial homes due to husbands' unpaid debts.

32 Simply stated, Sexually Transmitted Debt occurs when a wife becomes responsible for her partner's financial debts after being convinced into taking on debt in her own name, sharing the responsibility, or taking on more risk than she knew about. On Sexually Transmitted Debt see, among many, S. Robertson, Self-Representation, Sexually Transmitted Debt and the 'Benchmark male': a Case Study, in Flinders Law Journal, 2014, at 229 et seq; D. Otto, A barren future? Equity's conscience and women's inequality, in Melbourne Law Review, vol. 18, 1992, at 808 et seq.; N. Howell, Sexually transmitted debt, in Australian Feminist Law Journal, 1995 at 100 et seq; A.J. Harper, Sexually Transmitted Debt: Credibility, Culpability and the Burden of Responsibility, Thesis, University of Adelaide, 2001; B. Fehlberg, Money and marriage: sexually transmitted debt in England, in International Journal of Law, Policy and the Family, 1997, at 320 et seq. For an overview of STD under the Italian law, see F. Amici, *Responsabilità patrimoniale dell'obbligazione e profili di vittimizzazione del coniuge: il fenomeno del sexually transmitted debt*, in *Rivista di Criminologia, Vittimologia e Sicurezza*, Vol. XIII – N. 3 – Settembre-Dicembre 2019, at 82 et seq.

33 While men can also fall victim to Sexually Transmitted Debt, women appear to be particularly exposed to this issue. See P. Baron, The Free Exercise of Her Will: Women and Emotionally Transmitted Debt, in 13 Law in Context, (1995), at 23-25

34 As pointed out by Lord Brown-Wilkinson in *Barclays Bank plc v. O'Brien* 1993 4 All ER 417 at 422-4. https://www.casemine.com/judgement/uk/5a938b3e60d03e5f6b82ba4f.