Household Debt and the Importance of Effective Private Insolvency Laws

The development of private household indebtedness since 2000

The US subprime crisis and the Spanish housing market crisis among others have recently raised awareness of the importance of securing the sustainability of household indebtedness. Figure 1 shows the debt-to-GDP ratios of private households for European countries in 2000, 2008 and 2013. Household debt-to-GDP ratios have risen in the past decade for most countries in the EU, especially in the credit boom phase between 2000–2008, which was accompanied by loose credit conditions, as well as excessive mortgage lending in some countries.

Countries in this graph are sorted descending by their debt-to-GDP ratio in 2013, with Denmark topping the list with the highest debt-to-GDP ratio of almost 140 percent in 2013, followed by countries like the Netherlands and Ireland with debt-to-GDP ratios of over 100 percent. Countries with low debt-to-GDP ratios of around or below 30 percent in 2013 were mainly Eastern European countries like Romania, Bulgaria, Lithuania, Latvia and Hungary. The biggest European countries, France and Germany, were positioned in the middle with ratios of between 55–65 percent.

Changes in debt-to-GDP ratios (in percentage points) between 2000 and 2008 and between 2008 and 2013 are displayed in Figure 2. In the first period, 2000 to 2008, every country except Germany experienced a rise in the debt-to-GDP ratio; whereas efforts to deleverage have intensified throughout Europe since 2008. Especially in the Eastern European countries of Estonia, Latvia, Hungary and Lithuania cited above, but also in Ireland, the United Kingdom, Iceland and Spain, household debt-to-GDP ratios declined from 2008 to 2013. In countries like Greece, Norway, Sweden and Finland, on the other hand, the debt-to-GDP ratios still rose between 2008 and 2013, with Greece and Norway experiencing the highest increase during that period. Interestingly, some of these countries like Norway, the Netherlands and Sweden already had high debt-to-GDP levels in 2008. Overall, Europe is divided almost exactly into countries that deleveraged and countries where debt-to-GDP ratios rose in recent years.

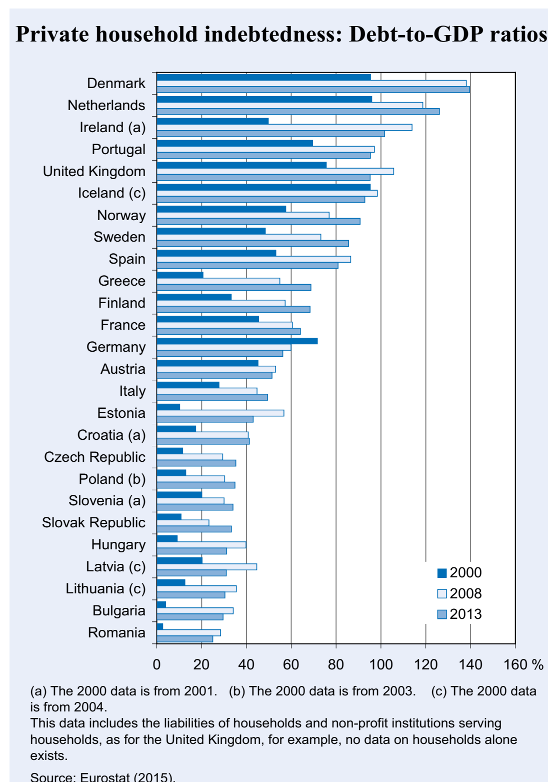
In 2012 the EU established the MIP Scoreboard (Macroeconomic Imbalances Procedure Scoreboard) as an annual early warning system consisting of eleven indicators covering the major sources of macroeconomic imbalances (European Commission 2012). Besides other macroeconomic indicators, the scoreboard gives information on debt-to-GDP targets and ratios: government debt should not exceed the well-known Maastricht criteria of 60 percent of GDP while private sector (including companies, households, etc.) debt should not exceed 133 percent of GDP.[1] Hence no overall target for private households alone officially exists to date.[2]

Reasons for becoming an indebted household

High household debt is usually a result of accumulating consumer debts. There are several reasons for consumer over-indebtedness that can be economic, but also

[1] When the scoreboard was established in 2011/2012 the threshold for the debt-to-GDP ratio of the private sector was 160 percent.
[2] There are several empirical studies which give hints for deleveraging needs of households, for an overview please see European Commission 2014 p.15.

Figure 1



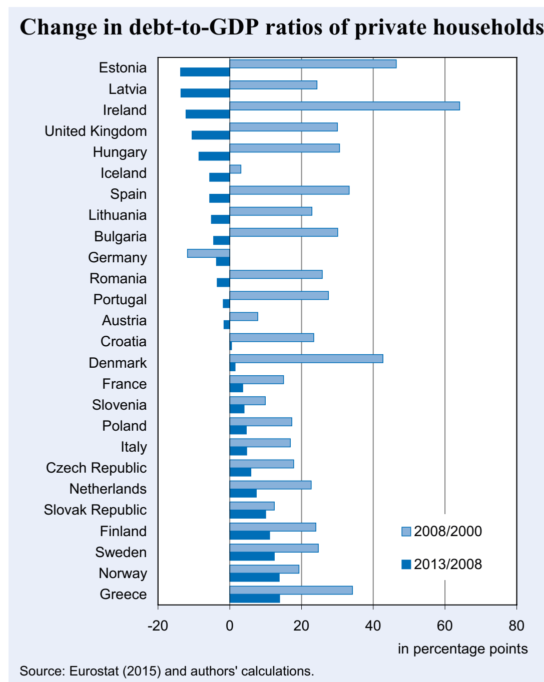
Private household indebtedness: Debt-to-GDP ratios

(a) The 2000 data is from 2001. (b) The 2000 data is from 2003. (c) The 2000 data is from 2004.
This data includes the liabilities of households and non-profit institutions serving households, as for the United Kingdom, for example, no data on households alone exists.

Source: Eurostat (2015).

Figure 2

Change in debt-to-GDP ratios of private households



Source: Eurostat (2015) and authors' calculations.

psychological/family-related. Among the main economic reasons are unemployment, the lack of a financial overview, business failure, excessive consumption and a lack of experience with banks (Ramsay 2012).

In the non-Euro countries in particular, but also in Austria, households are indebted in foreign currencies like the euro and the Swiss franc because these foreign currency loans had lower interest rates than loans in the national currency. A lack of consumer protection and information guidelines addressing possible risks about excessive consumption on credit, particularly regarding the exchange rate risks associated with foreign currency loans, are one explanation for the rising indebtedness. With the appreciation of the Swiss Franc after January 15th 2015, foreign currency loans in Swiss francs became an even bigger problem for the debtors holding these loans causing serious problems for a considerable number of households in countries like Austria, Poland and Hungary (The Economist 2015; Fisher et al. 2015).

Ways to reduce household debt

High household debt becomes a problem when it prevents private individuals from taking part in economic life. Households that are heavily indebted reduce household consumption. Therefore, a severe debt overhang on the part of private households can threaten economic growth. To counter this challenge several forms of active deleveraging can be pursued (European Commission 2014): negative credit flows (active debt repayment); changes in outstanding nominal debt via valuation changes (e.g. due to foreign currency denomination) and debt write-downs/restructuring; real GDP growth; and inflation (measured by the GDP deflator).

In the following we will focus on debt write-downs or restructuring via private insolvency laws, which have recently been implemented in a number of (East European) countries. These offer institutionalized ways of directly dealing with high household debt and avoid the severe macroeconomic side-effects of devaluations. In recent times, some governments have achieved debt-write downs via ad-hoc measures like the haircuts on loans or mortgages (see, for example, the case of Croatia, Government of the Republic of Croatia 2015). These measures can be criticized as they interfere with private contracts, damage the rule of law, induce moral hazard and undermine credit discipline, which creates negative incentives for private households to continue to run up excessive debt (Liu and Rosenberg 2013).

Private insolvency laws for debt restructuring

Private insolvency laws have several purposes (also referred to as consumer/individual insolvency laws). In general, they aim to establish balanced and predictable burden sharing between debtors and creditors (Liu and Rosenberg 2013). On the one hand, such laws should help individuals to make a "fresh start" after a certain period of repayment by discharging their remaining debts that cannot be served. This is necessary to enable indebted persons to fully participate in the economic life again (Christopherson and Abjornsson 2011). On the other hand, insolvency laws should maintain credit discipline and prevent moral hazard. A legal framework on consumer bankruptcy should remove uncertainty about indebtedness and provide a standard framework for dealing with indebtedness for both debtors and lenders. In addition, out-of-court settlement for distressed mortgages, voluntary guidelines or codes of conduct could also provide guidance on mortgage restructurings for borrowers in financial distress.

Consumer bankruptcy regulations structure consumers' debt payments and limit the amount of earnings that can be spent on individuals' living expenses. In general, there are two opposing models of consumer insolvency laws: the Anglo-Saxon and the continental European

Table 1

Private insolvency laws in Europe

Country	First effectiveness/ major reforms	Clusters for duration of discharge period		
		Short (shorter than 3 years)	Medium (between 3 and 5 years)	Long (longer than 5 years)
Austria	1995			x
Belgium	1998		x	
Bulgaria	Currently no law			
Croatia [a]	Currently no law			
Czech Republic [b]	1991 / 2008		x	
Denmark	1984		x	
Estonia	2004		x	
Finland	1993		x	
France	1989 / 1998	(x)	x	
Germany	1999 / 2014		(x)	x
Greece	2010		x	
Hungary	Currently no law			
Ireland	1988 / 2012		x	
Italy	2012		x	
Latvia	2008 / 2010	(x)	x	
Lithuania	2013		x	
Netherlands	1997		x	
Poland	2009	(x)	x	
Portugal [c]	2004 / 2012	See footnote		
Romania	Currently no law			
Slovak Republic	2007		x	
Slovenia	2008		x	
Spain [d]	2003 / 2013	See footnote		
Sweden	1994		x	
England & Wales	(1881)/2002	x		
Norway	1993		x	

Notes: In some countries (like Germany and Latvia) the discharge period can be shortened when fulfilling special requirements (x percent of all debts must be repaid for example). These shorter periods are shown in brackets.
[a] A proposal to establish a consumer law was presented to the Croatian parliament in June 2014. On March 13th 2015 the Croatian government endorsed the personal bankruptcy bill.
https://vlada.gov.hr/news/government-endorses-personal-bankruptcy-bill/16540
[b] Before 2008 the insolvency law recognised the traditional bankruptcy proceedings for consumers.
[c] In Portugal a law establishing a special regime to protect housing loan debtors in the dire economic situation of September 2012 applies to mortgage debtors who meet certain conditions such as low income levels, the suffering of income loss, real-estate value loss, and the existence of no other assets.
[d] The bankruptcy law is only designed for corporate and self-employed individuals whose debt is tied to business; debt relief for individuals for mortgage debt is possible since 2013.

Source: Ramsay 2012; Niemi 2012 and authors' research.

model. The first stands for a liberal ''fresh start'' policy and is common in the United States, Canada, England and Commonwealth countries. It is referred to as a "Fresh Start" system, since debtors can discharge their debt via bankruptcy and continue their lives free of their existing debt without the need to follow a "payment plan" over a certain time period (Ramsay 2012). The continental approach, on the other hand, consists of a long-lasting procedure, which allows for a fresh start only after a long period of distress and sanctions during which individuals have to live on minimum subsistence and need to contribute all excess earnings to their creditors ("earned start") (Ramsay 2012). Laws within the continental approach mainly differ with regard to the duration of repayment and recuperation period.

Table 1 gives an overview of private insolvency laws in Europe. The German law, for example, is considered as

creditor-friendly: the discharge period is six years and can only be shortened to three years if the debtor is able to repay at least 35 percent of his/her debts. In Latvia, which is seen as debtor-friendly, the maximum recharge period is 3.5 years, which can be shortened to one year. Apart from those countries with very long discharge periods like Austria and Germany, there are still countries with an insufficient (Spain, Portugal) or even no private insolvency law at all (Bulgaria, Hungary and Romania). Overall, European laws are moving towards shorter discharge periods. In recent years most new laws or revisions had a discharge period ranging from 3–5 years.

As there is no common insolvency procedure on EU level and no standardized discharge period, the problem of insolvency tourism (Hoffmann 2012) arises as consumers try to open a bankruptcy act in countries with more favourable bankruptcy laws (mainly because of shorter discharge periods) like England or France (Alsace region).

Preventive measures

Additional measures need to be implemented to prevent households from falling into over-indebtedness. Loose credit conditions and uninformed customers were the main drivers behind debt accumulation over the last decade. Therefore guidelines for banks with regard to the kind of information about possible risks that is provided to customers (especially when dealing with foreign currency loans), as well as debt counselling and financial education for individuals should be established and fostered to prevent severe household debt. In April 2011 the European Commission published a proposal for the legislation of 'responsible lending and borrowing'. This proposal includes a range of preventive measures such as requiring a standardized pre-contractual information sheet, having a mandated period where the borrower has the right to withdraw, and regulating advertisement and testing credit worthiness (European Commission 2011 and 2013).

Conclusion

Enduring household debt can have negative externalities on the whole economy as it constrains consumption and, by extension, economic growth. One measure for reducing the household-debt-to-GDP ratio is to reduce household over-indebtedness via debt restructuring. An effective consumer insolvency law represents a reliable instrument for adequately sharing the debt burden between creditor and debtor.

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