Consumer Credit, Debt & Bankruptcy
Comparative and International Perspectives

EDITED BY
Johanna Niemi, Iain Ramsay and William Whitford
After a long period of prosperity and steady economic growth, the world’s leading economies are now in crisis, and although there will be debate about its origins, the scale and seriousness of the crisis is in no doubt. There is also no doubt that excessive amounts of consumer credit, allied to a weak understanding of how globalised credit markets might react to a crisis, have played a significant part. This book, which is primarily about credit, debt and the trouble they have led to, is written by authors who have specialised in researching into overindebtedness, that is, situations in which an individual’s debt burden has become overwhelming. For these authors the plight of individuals is a primary concern, but the wider issue is how credit is used and how it changes societies.

The essays in this volume, addressing topics which are fundamental to our understanding of the current crisis, range widely across the whole sector of consumer finance, including mortgages, ‘credit binges’, the regulation of consumer lending, insolvency, repayment plans, debt counselling and much more besides. The conclusions drawn from the book are equally wide-ranging, but above all the lesson learned from these essays is that the financialisation of contemporary life ensures that issues of the appropriate role of credit remains of critical importance in society.
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Johanna Niemi
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OXFORD AND PORTLAND, OREGON
2009
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Introduction

JOHANNA NIEMI, IAIN RAMSAY, WILLIAM C WHITFORD

THIS IS A book about credit, debt and trouble. The authors of the book do research on overindebtedness, that is, on situations in which the debt burden of an individual has become overwhelming. Some of them also work closely with debtors or institutions, organizations and people who help those that are overindebted. Thus, they have seen the downside of credit. Yet the authors also see credit as a positive force in society. As Professor Jose Reinaldo Lopez put it at the conference from which the articles in this book originate, credit can and should be used as an inclusive factor that promotes inclusion of people to society. The real issue is how credit is used and how it changes societies. In an idealistic but at the same time conservative vein Udo Reifner argues that credit should be productive.

As the now-extensive research on overindebtedness shows, credit has not been productive for all debtors. During the past two decades we have seen an overall trend that has increased the income and wealth gap between the rich and the poor. While credit and debt are resources that can and do help poor and middle-class families to improve their lot, they also make the circumstances of many families much worse, even causing a regression from the middle to the lower classes. The current crisis stemming from the US housing market is a prime example of that. Ordinary people have also suffered from the economic crises over the past two decades in many other parts of the world, for example in Europe in the early 1990s and in the Asian countries in the late 1990s.

Each of these overindebtedness crises has had an impact on the regulation of consumer overindebtedness and insolvency but the impact has varied in different countries and different parts of the world. This book has resulted from a long-term commitment by the authors of this introduction and many others that a comparative study is fruitful in understanding consumer overindebtedness, the reasons for it and possible legal responses to it. This commitment has resulted in an informal network of academics and activists from around the world, many of whom met in Berlin in July 2007 as part of the meetings of the Law and Society Association. Over 30 papers on overindebtedness were presented and discussed, by approximately 50 participants. All papers included in this book were first presented at this Berlin conference. All papers took some kind of socio-legal approach to the topic, and many included the results of original empirical research.
Earlier meetings on the effects of consumer overindebtedness have tended to focus on insolvency law. For the Berlin meetings and for this book a conscious and successful effort was made to expand the range of papers. The globalization of the credit markets has continued and lending by international lenders has gained new consumer markets in different parts of the world, especially Central and Eastern Europe, Latin America and Asia. At the same time, lenders have been looking for new market segments in the mature credit societies, adapting the loans to the means and possibilities of the new borrowers. Part 1 of this book contains several Chapters describing these developments in consumer credit markets in different parts of the world.

Part 2 of the book contains Chapters focusing on new attempts to regulate consumer credit markets to limit the effects of this credit expansion in creating overindebtedness. The phrase ‘responsible lending’ has become part of our vocabulary, as discussed in many of these papers.

Insolvency law remains an important focus of the materials. Insolvency procedures are a way to treat overindebtedness, to ameliorate some of the adverse consequences for debtors. Part 3 of the book contains articles discussing the effects of overindebtedness on insolvency filing rates and changes in insolvency procedures in many countries. Part 4 focuses on repayment plans, which is the only available insolvency procedure in many countries and in others has become an important alternative to discharge-focused insolvency procedures.

I. CHANGING CONSUMER CREDIT MARKETS

After a long period of prosperity and steady economic growth, the western hemisphere experienced in 2007 unmistakable signs of economic trouble. The seriousness of the crisis was first manifested to the general public by the crisis of the US housing market. The globalization of the credit markets suggests that the repercussions of the housing loan crisis will be felt all over the world.

Both Gregory Squires and Christopher L Peterson provide background to this crisis. Gregory Squires examines how the disparities in levels of income and property have been increasing and analyzes the impact of this development on the US credit market. Squires notes that all subprime lending is not necessarily predatory, but patterns of predatory lending can be found in this market. Squires identifies several characteristics of predatory lending, which all point in the same direction: the poor pay more.

Developments in the home mortgage market are explained by Christopher L Peterson in his comparative article. Home mortgage lending was until recently

1 Two of the earlier meetings were also organized as part of a Law and Society Association conference held in Europe. The first was in Glasgow in 1996, and the papers were published as a special issue of *The Journal of Consumer Policy* (vol 20, pp 133–287), edited by Niemi, Kiesiläinen and Ramsay. The second meeting was held in Budapest in 2001, and the papers were included in Niemi, Kiesiläinen, Ramsay and Whitford (eds), *Consumer Bankruptcy in Global Perspective* (Oxford, Hart Publishing, 2003).
considered as the most secure form of credit, for both debtors and creditors. The market has changed as underwriting practices have relaxed, facilitated greatly by the growth of a secondary market for bundled mortgage loans. It seems, however, that the risks involved with the expansion of credit and reaching new groups of debtors have not been understood by the regulators nor anticipated by the markets. Comparatively, the markets in Germany and Japan seem to be so much behind in the development of new securitization instruments that a similar crisis as in the US is likely to be avoided.

The expansion of credit has taken different and perhaps more anticipated forms in other parts of the world. Several articles in this book illustrate the growth of the consumer credit market, its consequences to the consumers and the reactions of the regulators in countries such as Brazil, Japan, Korea, South Africa, Australia, Great Britain and Germany. Brazil provides a telling example. While the level of poverty has decreased over the last decade, outstanding credit by individuals and households has increased eight-fold and the number of credit cards is now almost four times as high as in 2000. Claudia Lima Marques and Antonio Benjamin report an increase in the debt problems experienced by the lower middle class that has gained access to credit in the ‘credit explosion’ during the last five years.

Debt problems are a recurrent topic in the media. Iain Ramsay takes up the picture of debtors that is painted by the media in his discussion of overindebtedness in the United Kingdom. Some of the terminology he describes is mainstream consumer credit and overindebtedness usage, like ‘credit crisis’ and ‘irresponsible or feckless borrowing’, but the more imaginative metaphors he has found, like ‘credit binges’ and ‘wannabe WAGs’, can be used to draw attention to the way debtors are commonly described as deviant, aberrant and ‘the other’. Ramsay also explores whether overindebtedness should be understood as a pathology of affluence, concluding that it is both a pathology of affluence and poverty in an affluent society.

II. CONSUMER CREDIT REGULATION

After the turn of the millennium the regulation of consumer credit has been under serious policy discussions at national and regional levels in many parts of the world. These discussions are often framed along two regulation strategies: the liberalization of the credit market and the empowerment of the consumer, who is assumed to follow the rational actor model in her decision making; and the regulation of both the procedure for granting of the consumer credit and the content of the resulting contracts, with the goal of ensuring fair and secure credit contracts that protect consumers. These contrasts suggest an initial distinction between ‘neo-liberal’ and ‘social market’ approaches to regulation of consumer credit, with the UK and US within the former model and countries such as Germany representing the other. Udo Reifner argues that a neo-liberal
approach favors extensive disclosures to consumers, and protection against unfair surprise in contracts. It relies primarily on the market to police credit provision but recognizes the need for responsible lending and borrowing: financial literacy is intended to achieve the latter goal. Extensive consumer credit reporting is viewed as a central part of the institutional framework of the market. Accessible bankruptcy procedures provide a ‘fresh start’ for consumers so that they can re-enter the credit economy. The World Bank has adopted the broad lines of this approach in its development of ‘best practices’ in consumer financial protection.\(^2\)

In contrast the ‘social’ model is based on the image of the ‘hasty and needy consumer, forced into contractual relations by social circumstances he cannot control’. Social consumer protection in credit markets includes ‘usury ceilings, capped default interest rates, protection against early termination and discharge, with warnings and information on debt’.\(^3\) Reifner also argues that consumer credit law provides a potential relational model of consumer law which recognizes the need to provide opportunities for contractual adjustment to unforeseen changes such as loss of employment. The Chapters in this Part explore the above distinctions in regulatory approaches and assumptions as they unfold in contemporary national and regional regulation.

In discourses on overindebtedness the aim of prevention is often mentioned as a goal of policies that would restrict lender behavior. Besides the national policies, which have emphasized prevention for a long time, the Council of Europe has taken an important initiative to promote a common approach to overindebtedness. The recommendation by the Council of Ministers of 2007 takes a broad approach to the prevention of debt problems. Johanna Niemi takes prevention of debt problems as the starting point in her article, which is based on a preliminary survey of national laws on enforcement, credit registration and debt adjustment laws of the European countries. The Chapter discusses the possibilities of prevention through the use of credit registration and use of default data, financial education and protection of debtors in the enforcement procedures. While promoting all these, she concludes that prevention can not replace rehabilitative procedures in a credit society.

Udo Reifner, a scholar and long-time proponent of consumer rights, approaches consumer credit in his article from a broad ethical perspective. Together with consumer protection organizations he has developed ethical principles for responsible credit. These principles are in the form of soft law, giving general guidelines for responsible credit.


The EU is committed to the creation of an integrated capital and credit market. There is also concern about overindebtedness. The Consumer Credit Directive (CCD) of the European Union, adopted in 2008, is primarily a measure aimed at market integration. However, it contained in an early draft a strong ‘responsible lending’ requirement referring to the responsibility of the lender to consult relevant databases on the creditworthiness of the consumer before extending a credit and to ensure that credit was suitable to the needs of the consumer. The proposal was watered down before the final CCD was accepted. There were also many other issues debated, such as the scope of disclosure obligations and the rights of withdrawal and early payment. The result was a compromise between the interests of the financial institutions and the consumer organizations on almost every point. Sefa Franken discusses in her article the political process around the directive with a focus on the influence of the interest groups. While the financial sector was organized and well represented in the consultations, the consumer side seems to have a weak representation and difficulties in forming its opinion. However, as Franken notes, the financial institutions are also a non-unitary group and their silence on some central issues may mean that there are differing opinions within the group. As Franken shows, a more open legislative process would be in the interest of all EU citizens.

Susan Block-Lieb, Richard L Wiener, Jason A Contone and Michale Holtje take as their starting point the economic model of the individual consumer as a rational actor. Disclosure regulation, strengthened in the US by recent amendments to the Truth in Lending Act, and in Britain by reform of the UK Consumer Credit Act 1974, presumes a rational actor in deciding what information must be provided by a lender. Drawing on the work of behavioral economists, Block-Lieb et al present the results of a simulated empirical experiment, suggesting that the emotional value of disclosure on debtors is more significant than the effects of greater understanding of contract terms resulting from the enhanced disclosure.

Nations have reacted to debt problems in different ways, as several Chapters of this book indicate. The increase in debt problems in South Africa brought into daylight a credit market that was divided along racial and social lines. Until recently regulation basically reached only the ‘upmarket’ for white middle-class debtors. Michelle Kelly-Louw’s article takes up the problems of debtors in the basically unregulated small-loans market, in which usury has flourished. The new consumer credit law is an ambitious attempt to regulate those loans, and includes both interest rate caps and a concept of reckless lending. Courts have the power to suspend the effect of offending credit agreements.

Souichirou Kozuka and Luke Nottage examine the growth and regulation of Japanese consumer credit, including a recently enacted responsible lending requirement, against the background of traditional justifications for regulation of
the economy in Japan. They argue that contemporary regulation does not fit with traditional cultural explanations about the relationship of law to the economy in Japan. After considering several theories of Japanese political economy, including elite management and public choice, as well as normative theories drawn from neo-classical and behavioral economics, they conclude that reforms may represent an increasing pluralism and perhaps populism in Japanese politics.

III. CONSUMER OVERINDEBTEDNESS AND INSOLVENCIES

The increasing debt problems of households have led lawmakers all over the world to seek new solutions and, thus, insolvency procedures for consumers have become more common in different parts of the world. Consumer bankruptcy or debt adjustment schemes, leading to partial or total relief of outstanding debt, have been the traditional answer to overwhelming debt problems in Anglo-Saxon jurisdictions. These schemes have also become increasingly common in European states (see Niemi; Kilborn; Backert et al) as well as in the industrialized Asian countries (see Oh; Kozuka and Nottage).

In all insolvency systems a key question is why debtors file. The Chapter by Ronald Mann, who earlier conducted an extensive comparative study of the variation in levels of consumer credit in different countries, compares the filing rates in several jurisdictions with a view to explaining what factors impact the different bankruptcy per capita rates in these jurisdictions. His main finding is that economic reasons are most important. Debtors in the US file consumer bankruptcy more often than in the other countries he studied (Canada, UK and Japan), not because they have a lax attitude to repayment of debts, but because they have more debt. The economic explanation does not exclude legal and cultural influences on filing behavior, however. Canadians, according to Mann, seem to have a lower threshold of filing for bankruptcy when they are overindebted than debtors in comparable countries. Mann argues that one explanation is the easy accessibility of bankruptcy in Canada, with low up-front payments and the lack of an effective requirement for a judicial determination of need for bankruptcy.

The issue of who are the debtors at risk of becoming overindebted or who have already become so are taken up by Catarina Frade and Claudia Lopes, Wolfram Backert et al and Johannes Doll. Frade and Lopes frame the issue about the households with the highest risk of becoming overindebted in a new way in their article with the concept of ‘financial stress’. They want to understand how overall economic variables affect how households experience financial stress across the European countries. Interestingly, they find that the prosperity of the country, as measured by GNP, the availability of credit to households and the relatively even income distribution all diminish the financial stress experienced by the non-poor households in Europe.

Wolfram Backert, Ditmar Brock, Götz Lechner and Katja Maischatz report on a study of debtors who have filed for relief under German consumer insolvency
procedure. Their findings confirm the results of earlier studies that unemploy-
ment, family breakdown and loss of financial overview are the most common
factors behind the overindebtedness, followed by business failure. Their study
also offers support to Mann’s thesis that easy accessibility of the insolvency pro-
cedure increases filing rates. A reform that made it possible to defer payment of
the filing fee seems to have accelerated the rise in consumer insolvencies in
Germany.

Some groups of consumers are more vulnerable to changes than others. One
group that is often pointed to as most prone to debt problems are the young.
Johannes Doll points out in his article that the elderly are also vulnerable to
overindebtedness. In Brazil the possibility of assigning future pension payments
for the payment of debt made the elderly an attractive group for the lenders and
exposed them to overindebtedness in an unprecedented way.

Jason Kilborn, who looks at the European consumer insolvency systems with
American eyes, distinguishes in his article about continental European countries
two trends in insolvency procedures over the last 10 years. First, cumbersome
accessibility criteria have been relaxed and the procedures simplified, at least to
some degree. Second, there are indications that access to discharge has been
made easier and special barriers abolished for debtors who have no or very
little payment capacity. Kilborn agrees with Mann in advocating simplified
procedures for these cases, called NINA (no income, no assets) or LILA (little
income, little assets).

IV. REPAYMENT PLANS

In the past comparative research on consumer bankruptcy has emphasized the
availability of a discharge of unpaid debt, whether access to the discharge is con-
ditioned upon repayment of some of the debt, and the institutional settings of
bankruptcy procedures. Today most countries sponsor repayment plans, with
or without a discharge option upon conclusion, and even common law countries
that traditionally have emphasized nearly unconditional access to a discharge
procedure increasingly emphasize repayment plans as an alternative. It is appro-
priate that scholars now look at the details of repayment plans and this Part con-
tains several papers that do so.

All repayment plans are designed to yield some partial repayment to credi-
tors. Some plans also offer the debtor a discharge and a financial ‘fresh’ start
after payment of some debt. Some plans have the further objective of ‘rehabili-
tating’ the debtor, through education, social assistance or other means, with the
aim of enhancing his or her future ability to cope responsibly with credit. This
multiplicity of goals is balanced in different ways in different national jurisdic-
tions, and that complicates the evaluation of repayment plans. For example, if
there is not an alternative of straight bankruptcy in the jurisdiction, discharge
achieved through a repayment plan can probably be judged a success. But if
unconditional, or straight, discharge is an alternative to a repayment plan, success is more difficult to define. Repayment might be considered a success for creditors, but it may not be the best course from the debtor’s perspective if a discharge could be obtained more quickly and at lower cost by a different procedure.

Jean Braucher discusses in her article the methodology of measurement and evaluation of success with payment plans, drawing on empirical evidence from the US, Australia and Europe. An obvious measure of success would be the completion rate of confirmed plans. This, however, is not easily measured because it requires a long-term follow-up. Repayment plans typically take three or more years after filing before they are concluded. Many studies give reason to suspect that a considerable portion of plans fail. Especially in those circumstances, straight discharge might be considered a more successful option; it may provide creditors less repayment but it does provide the debtor some debt relief and at least a partial fresh start. Further, many payment plan schemes incur high administrative or legal costs, which are borne by the debtors, creditors and the taxpayers in different mix, and that has to be considered in evaluating repayment plans, especially in jurisdictions with a straight bankruptcy alternative.

The other Chapters in this Part of the book take up country examples of repayment plans. The backgrounds and contexts of these countries are different. The Australian repayment plans have been introduced in a bankruptcy system that has historically allowed immediate discharge but has had cost barriers and punitive effects for individual bankrupts. As John Duns and Rosalind Mason report, new debt agreement schemes with a repayment plan have been popular and the debtors have succeeded relatively well. However, Jean Braucher is more cautious, reminding us that the completion rates of the plans have not yet been followed long enough and that the goal of rehabilitation might have been reached in some cases more efficiently through a bankruptcy scheme.

After Korea experienced an explosion of consumer lending, followed by a realization that many of the debts could not be repaid as due by debtors, the Korean consumer insolvency law developed from a no-discharge bankruptcy law to a system that offers debtors several options. Sooegun Oh compares a workout program created by a covenant among the most important financial institutions in 2002, and a judicial rehabilitation process adopted in 2004. The workouts have come to be gradually outnumbered by the rehabilitations, which give a possibility to a more radical reduction of debts through a three- or five-year plan instead of an eight-year plan as in the workouts. Unlike the judicial rehabilitation process, however, the workouts also give protection to guarantors and to some extent against secured creditors, and consequently some debtors quite rationally still gravitate to the workout procedure.

England and Wales has now developed a variety of repayment alternatives for debtors which, when fully implemented, will provide a potentially complex array of public and private options to a debtor. These include: straight bankruptcy with the possibility of income repayments over a period not exceeding
three years; a reduced fee debt relief order—effectively bankruptcy—which will be available to low-income debtors with no assets and debts of under £15,000; an administration order for individuals with debts under £15,000 which promises the possibility of a write-off of debt after five years for those individuals successfully maintaining repayments; individual voluntary arrangements permitting debt composition and repayments normally over five years; private debt management plans usually without composition but with the possibility that the government may authorize certain private plans to write off debts. This complexity is partly a result of a lack of overall planning and competing departmental responsibilities. Government policy seems to support partial repayment rather than ‘straight’ bankruptcy as the central mechanism for overindebted debtors although such a policy has never been presented to Parliament. Michael Green describes the evolution of the payment alternatives since the beginning of the century, highlighting the extent to which the development of the Individual Voluntary Arrangement (IVA)—now viewed as the primary consumer remedy for overindebtedness—was developed by entrepreneurial insolvency practitioners who adjusted an existing commercial device to the mass consumer market. He also draws attention to the need for regulation of this private market for debt resolution.

Finally, the Dutch consumer bankruptcy law, enacted in 1998, has the unique background of a system in which discharge and partial repayment were based on contractual agreements between a debtor and his or her creditors, with the debtor supported by municipal banks both in negotiations and through financial contributions. The old system also put a lot of emphasis on the rehabilitation by evaluating a debtor’s problems and offering social services. As Nadja Jungmann and Nick Huls describe, one purpose of the new law was to facilitate such negotiations and make informal settlements more enticing for the creditors. In practice, however, the amicable old system has been partially replaced with a more standardized and bureaucratic judicial procedure, which creditors seem to prefer even though it probably offers lesser repayment than is achievable through resort to the older preferred procedure. Nonetheless, the emphasis on repayment and the socially minded financial institutions are still part of the Dutch culture, reminding the rest of the world that there is a need for social banking and responsible credit all over the world.

The financialization of contemporary life ensures that issues of the appropriate role of credit, the legitimacy of differing types of credit, and regulation of the ground rules and pathologies of consumer credit, will remain important. The Chapters in this book demonstrate that although there may be significant international pressures towards the adoption of neo-liberal approaches to regulation, there are competing voices and regulation rarely follows strictly a neo-liberal template. Different countries’ regulation may reflect particular conjunctures of events, interest groups and ideology. This conclusion is of general interest to the international and comparative study of the regulation of consumer markets.
1

Inequality and Access to Financial Services*

GREGORY D SQUIRES

_Predators_

If you can’t maintain a certain amount
No banker’s going to let you have a checking account
So when you gotta cash a check ’cause your kids need to eat
There’s a check cashing place about a block up the street
When the money’s tight, you don’t have to wait
There’s a 500 percent interest rate
That you keep rolling over on that payday loan
And if you can’t afford a freezer you can rent-to-own
You gotta make those payments for you can’t miss one
You can buy it three times over by the time that you’re done
If you do miss a payment, they will repossess
And when your ice cream melts, it’s going to make a mess
’Cause they’re predators, predators, they keep devouring more and more
they’re predators, predators that keep gettin’ richer by preying on the poor

Rap song: Predators Music and lyric by
Clifford J. Tasner & Wil b.@2006 by
Tasner Tunes & Lu Chi Fu Music
All Rights Reserved
From the Film: In Debt We Trust: America Before the Bubble Bursts

I. INTRODUCTION

Consumer debt has increased dramatically in recent years, and in ways that threaten the financial security of many poor families, working households, and even some who ascended, perhaps just temporarily, into the middle class. Characterized as ‘overindebtedness’,¹ a ‘debt

* I would like to thank Marlene Kim and Sara Pratt for many helpful comments on earlier drafts of this paper.

explosion”\(^2\) and an ‘addiction to credit’\(^3\) the increasing reliance of consumers worldwide on credit has attracted widespread attention from policymakers, academics, community organizations and many others.\(^4\) In the United States credit card debt alone grew from less than $10 billion in 1968 to over $800 billion in 2005. Total consumer debt reached $2.1 trillion in 2005. Among lower-income households 55 percent were in debt in 2004, a ten percent increase since 1989, with total debt held by these households increasing by 308 percent in this period.\(^5\) Personal bankruptcies increased from less than 4 per 1,000 households in the 1950s to 52 per 1,000 in the late 1990s. More than 1.6 million filed for bankruptcy in the 12 months prior to June 2005, approximately twice the number who filed 10 years earlier.\(^6\) In 2005 the personal savings rate dropped below zero (meaning that people spent more than they earned) for the first time since the Depression, perhaps the clearest signal of a growing financial crisis.\(^7\) The accompanying expansion of credit, sometimes by consumer choice, sometimes in response to aggressive marketing by financial institutions, reflects restructuring of financial services in many ways.

But a more fundamental transformation shaping credit practices is a dramatic increase in economic inequality. Understanding recent restructuring of financial services, the economic and social costs that ensue, and what to do about those costs requires an understanding of those larger changes, what Lester Thurow (1986)\(^8\) referred to 20 years ago as a ‘surge in inequality.’ In her recent book on educational reform Jean Anyon (2005)\(^9\) argued that recent trends in poverty and inequality created conditions that no school reform could transcend and that macroeconomic policies shaping the broader distribution of income, wealth,
and poverty need to be addressed as part of any meaningful educational reform effort. A similar observation applies to financial services. Coming to terms with broader questions of inequality is essential for any meaningful changes in the delivery of, and access to, financial services, at least on fair and equitable terms.

Over the past three decades, the trajectories of inequality that have most dramatically changed the face of the nation’s metropolitan areas are the persistence of racial segregation, concentration of poverty coupled with increasing economic inequality, and sprawl. All of these forces, fuelled by intentional public policies and institutionalized private industry practices, have given rise to the uneven development of metropolitan areas. The following pages examine the connections between that uneven development and the evolution of financial services, particularly as they affect mortgage lending in the US. The paper concludes with directions for policies to ameliorate that uneven development and the ensuing inequality along with the associated costs, and to provide more equitable access to financial services.

II. SURGING INEQUALITY

By virtually any measure economic inequality has increased in recent decades. Between 1967 and 2005 the share of income in the US going to the top quintile of all households increased from 43.6 percent to 50.4 percent while the share going to the bottom fifth dropped from 4.0 percent to 3.4 percent. In 1967 those in the top fifth received four times as much as those in the bottom fifth. By 2005 the top group was receiving five times as much.\(^\text{10}\) Since the mid 1970s compensation for the 100 highest paid chief executive officers increased from $1.3 million or 39 times the pay of the average worker to $37.5 million or more than 1,000 times the pay of a typical worker.\(^\text{11}\) Further evidence that those at the very top are receiving most of the rewards was provided in 2004 when those in the top 1 percent enjoyed a 12.5 percent increase in their incomes compared to 1.5 percent for the remaining 99 percent.\(^\text{12}\) Wealth, of course, has long been much more unequally distributed than income, and that inequality has increased over time. Between 1983 and 2001 the share of wealth held by the top five percent grew from 56.1 percent to 59.2 percent. Racial disparities yield a similar pattern with wealth being much more unequally distributed than income. While African Americans and Hispanics earn approximately two-thirds the income of whites, wealth holdings for the typical non-white family are approximately one-tenth that of the typical white family. And while these gaps close moderately when

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controlling for education, occupation and related socio-economic characteristics, they persist at significant levels.\textsuperscript{13}

These inequalities have contributed to the uneven development of the nation’s metropolitan areas. This is most vividly demonstrated by the concentration of poverty, racial segregation if not hypersegregation of neighborhoods, and the associated patterns of urban and suburban sprawl. These spatial developments, in turn, dramatically affect the quality of life in different neighborhoods.

The concentration of poverty in the US has been the focus of much social science research and policy analysis for several decades. Between 1970 and 2000 the number of high-poverty census tracts (those where 40 percent or more of the population is poor) grew from 1,177 to 2,510 and the number of people living in those tracts grew from 4.1 million to 7.9 million.\textsuperscript{14} The isolation of rich and poor families is also reflected by the declining number of middle-income communities. Between 1970 and 2000 the number of middle-income neighborhoods (census tracts where the median family income is between 80 percent and 120 percent of the median family income for the metropolitan area) dropped from 58 percent to 41 percent of all metropolitan area neighborhoods. And whereas more than half of lower-income families lived in middle-income neighborhoods in 1970, only 37 percent of such families did so in 2000. The share of low-income families in low-income areas grew from 36 percent to 48 percent.\textsuperscript{15}

Even longer-standing patterns of racial segregation persist. Nationwide the black/white index of dissimilarity did decline from .73 to .64 between 1980 and 2000. (This index varies from 0 to 1 where a score of 0 would indicate that each neighborhood had the same racial composition of the metropolitan area as a whole and a score of 1 would represent total segregation meaning every neighborhood was either all black or all white. Scores above .60 are widely viewed as reflecting high levels of segregation.) In the large metropolitan areas where the black population is most concentrated, however, segregation levels persist at high levels, reaching at or near .80 in New York, Chicago, Detroit, Milwaukee and many other metropolitan areas. Lower levels have been achieved primarily in western and southwestern communities with small black populations and far less likelihood that whites would have frequent encounters with African Americans than would be the case in metropolitan areas with large black populations if all groups were more evenly distributed throughout the community.

\textsuperscript{13} TM Shapiro, \textit{The Hidden Cost of Being African American: How Wealth Perpetuates Inequality} (New York, Oxford University Press, 2004); National Community Reinvestment Coalition and Woodstock Institute, \textquote{A Lifetime of Assets} (Washington, DC and Chicago, National Community Reinvestment Coalition and Woodstock Institute, 2006).


For Hispanics and Asians segregation levels are much lower, approximately .4 and .5, but they have remained at that level or actually increased slightly during these years.\textsuperscript{16}

Reflecting and reinforcing these patterns of concentrated poverty and segregation have been land use patterns characterized by the term ‘sprawl.’ As Anthony Downs observed: ‘Suburban sprawl has been the dominant form of metropolitan-area growth in the United States for the past 50 years.’\textsuperscript{17} To illustrate, between 1950 and 1990 metropolitan areas grew from 208,000 square miles housing 84 million people to 585,000 square miles housing 193 million. So land use grew by 181 percent while the population increased by just 128 percent. Population density declined, therefore, from 407 to 330 persons per square mile.\textsuperscript{18}

III. COSTS OF UNEVEN DEVELOPMENT

These patterns of development embody severe social costs which have adverse consequences for entire metropolitan areas. But the costs are not evenly distributed. For many, particularly residents of low-income and minority communities, a range of opportunities are limited for reasons that go beyond the characteristics of those particular individuals. That is, there are neighborhood effects that frame the opportunity structure for access to virtually all goods and services available in the US, including financial services.\textsuperscript{19}

Perhaps the most immediate costs result from both a skills and spatial mismatch whereby those most in need of jobs (low-income residents of central city neighborhoods) lack the skills for nearby jobs, and live the greatest distance from the suburban and ex-urban areas where job growth is concentrated. As manufacturing jobs in urban communities have disappeared\textsuperscript{20} and professional service jobs have increased in downtown central business districts but even more so in suburban and ex-urban rings, poverty has become increasingly concentrated in inner-city neighbourhoods.\textsuperscript{21}


\textsuperscript{20} The share of non-agricultural workers employed in manufacturing dropped from 40 percent to 14 percent between 1979 and 2004, representing a total loss of 5.2 million manufacturing jobs. JS Hacker, \textit{The Great Risk Shift} (New York, Oxford University Press, 2006) 80.

But social costs emerge much earlier in life. Health care services from the very start of the life cycle are particularly unevenly distributed. For example, in the affluent and predominantly white northwest side of Washington, DC and the neighboring suburb of Bethesda, Maryland there is one pediatrician for every 400 children, compared to one for every 3,700 in the District’s predominantly poor and black southeast side. And in the predominantly black and Latino South-Central Los Angeles community there is one primary care physician for every 12,993 residents, compared to one for every 214 in the nearby wealthy community of Bel-Air.

The quality of public schools varies dramatically in large part because funding is based primarily on local property taxes. Wealthy communities can tax themselves at a much lower rate and still have far more to spend per pupil. To illustrate, in the 2002–03 school year the city of New York (where 72 percent of the school population was black or Hispanic and 83 percent of the students were eligible for free or subsidized lunches) per-pupil expenditures were $11,627 compared to $22,311 in suburban Manhasset (where 9 percent of the school population was black or Hispanic and 5 percent qualified for subsidized meals). Similarly in Philadelphia, where 79 percent of the students were black or Hispanic and 71 percent were poor, per-pupil expenditures were $9,299 compared to $17,261 in nearby Lower Merion where 9 percent of the students were black or Hispanics and 4 percent were poor. Similar disparities prevail in most major metropolitan areas.

But it is not just distressed households and poor neighborhoods that pay. Ghettos and barrios in the nation’s metropolitan areas, be they in central cities or inner ring suburbs, undermine the political stability, social development, and economic growth of the entire region. Cities with large poor populations and high levels of concentrated poverty pay more for a range of public services (including education, police, health care, and fire protection), increasing taxes and reducing their ability to attract middle-class families along with the resources they bring. Metropolitan areas with particularly high levels of income inequality grow more slowly than those where income is distributed more equally. In turn, the competitiveness of the nation’s economy generally is undercut. Uneven development is costly to all parts of many metropolitan areas and to the US overall in an increasingly global world.

IV. UNEVEN DEVELOPMENT AND FINANCIAL SERVICES

The world of financial services has hardly been immune to these forces. In many ways, restructuring of financial services both reflects and reinforces these patterns of inequality and uneven metropolitan development. A two-tiered system of financial services has emerged, one featuring conventional products distributed by banks and savings institutions primarily for middle- and upper-income, disproportionately white, suburban markets, and the other featuring high-priced, often predatory products, offered by check-cashers, payday lenders, pawnshops, and others targeted at low-income and predominantly minority communities concentrated in central cities.27

Perhaps the most concrete sign of these changes is the decline in branch banks and the rise in check-cashers and other fringe bankers, particularly in distressed neighbourhoods.28 As Federal Reserve Board researchers have reported, the number of branch bank offices in low- and moderate-income areas dropped by 21 percent while they increased by 29 percent overall between 1975 and 1995.29 As of 2005, banks remained concentrated in high-income areas. And the racial gap was even larger with more than twice as many banks per person in white as in non-white neighbourhoods.30 Meanwhile check-cashers, which are concentrated in distressed neighborhoods, increased their numbers from 2,151 in 1986 to 22,000 in 2003.31 And these are not just small ‘Mom and Pop’ businesses. They process approximately $60 billion in checks annually generating a fee income of $1 billion.32 Often they are financed by mainstream financial service...
providers like Citibank, Bank of America, and Wells Fargo. It should also not be lost that a key reason why fringe bankers are able to flourish is that market opportunities were created for them by the withdrawal of mainstream financial institutions from these markets.

Traditionally these services have been concentrated in the nation’s most distressed areas, though in recent years they have been expanding to working class communities as well. For example, in 1996 there were two banks for each check-casher in the central city but 10 banks for each check-cashing business elsewhere in the Milwaukee metropolitan area. In predominantly black neighborhoods there was one bank for each check-casher compared to 15 banks per check-casher in white areas. In North Carolina one study found African American neighborhoods had three times as many payday lenders as white neighborhoods, even after controlling on neighborhood income, homeownership, poverty, unemployment, education and other socio-economic factors. Another study found one check-casher for every 3,196 Denver residents in neighborhoods with median incomes below $30,000 compared to one for every 27,416 residents in areas where the median income was between $90,000 and $120,000. The ‘unbanked’ (households that do not have a bank or credit union account) are also not randomly distributed. The Joint Center for Housing Studies at Harvard found in a 2004 survey that 52.4 percent of the unbanked were black and 35.3% were Hispanic even though each of these groups constitute roughly just 12 percent of the population.

As with the poverty and race patterns reported above, these are not simply statistical curiosities. They reflect significant cost of living disparities as well. The California Reinvestment Coalition found that users of check-cashing businesses and payday lenders spend approximately $1,000 more annually than these services would cost at a mainstream bank. The Center for Responsible Lending concluded that payday lending costs US families $4.2 billion per year in excessive fees. Contrary to industry assertions that check-cashers and payday lenders basically provide a convenience that families only occasionally use when they are temporarily in need of cash, one study found that more than half of

those who take out payday loans participate in seven or more transactions with a lender in a typical year\textsuperscript{40} while another found that 90 percent of payday lender clients take out five or more loans per year.\textsuperscript{41} Families without bank accounts pay as much as $15,000 over a lifetime in fees to check-cashers and payday lenders for basic financial services.\textsuperscript{42}

Other kinds of fringe bankers have grown as well. Rent-to-own stores grew in numbers from eight in 1986 to over 2,500 in 2003.\textsuperscript{43} Pawn shops, long a symbol of low-income neighborhoods, doubled their numbers between 1985 and 2004 from 7,000 to 14,000, today outnumbering credit unions and banks.\textsuperscript{44} Auto title loans, refund anticipation loans, tax preparation services, and many others are part of a growing fringe banking industry offering a range of high-priced financial services to those least able to pay.\textsuperscript{45} In recent years, the greatest attention has been paid to the rise of subprime and predatory mortgage lending.

One of the most dramatic changes in financial services in recent years has been the explosion of mortgage products. Just one generation ago most borrowers applied for a conventional loan and were either approved or denied. Before the subprime mortgage crisis became almost daily news headlines toward the end of 2006, lenders offered dozens, if not hundreds, of products. With the advent of risk-based pricing, lenders offered an array of products priced in most cases according to the risk borrowers pose. So in addition to what was formerly a fairly standard fixed-rate 30-year loan, in recent years there have been many options including interest only, payment optional, variable rate, and many other loan types.\textsuperscript{46} So-called ‘nontraditional’ mortgages accounted for more than one-third of all mortgage loans during the first nine months of 2006 compared to 2 percent just six years earlier.\textsuperscript{47} One result has been a significant increase in high-priced, subprime mortgage loans which enable many families with blemished credit records to obtain a loan and become a homeowner who, just a few years ago, would not have been able to do so. Subprime lending has expanded exponentially in recent years. Between 1994 and 2005 the annual dollar volume of such loans grew from $35 billion to more than $600 billion. This represented

\textsuperscript{40} Community Reinvestment Association-North Carolina, Consumer Federation of America, Consumers Union, National Community Reinvestment Coalition, National Consumer Law Center, and US Public Interest Research Group, Letter to Members of the 107th Congress, 2 October 2002.

\textsuperscript{41} U King, L Parrish and O Tanik, ‘Financial Quicksand: Payday Lending Sinks Borrowers in Debt with $4.2 Billion in Predatory Fees Every Year’ (Durham, NC, Center for Responsible Lending, 2006).


\textsuperscript{43} H Karger, Shortchanges: Life and debt in the fringe economy (San Francisco, Berrett-Koehler Publishers, Inc, 2005) 95.

\textsuperscript{44} Ibid, 66–7.

\textsuperscript{45} MS Barr, ‘Banking the Poor’ (2004) 21 Yale Journal on Regulation 121–237.


an increase from 5 percent to 20 percent of home-loan originations.\textsuperscript{48} Homeownership rates have reached record levels in recent years, which many attribute to the availability of subprime loans. But this argument has been challenged by recent research documenting that most subprime loans are for refi-
nancing rather than purchase, and the number of families losing their homes as a result of default and foreclosure on these loans far exceeds the number who became homeowners.\textsuperscript{49} Not unrelated has been far greater attention to unscrupulous, predatory practices in the mortgage lending market. Once again, the impact has not been randomly felt in US cities and metropolitan areas.

In part as a result of the debate over predatory lending, lenders have been required to publicly report pricing information on some loans beginning with their 2004 Home Mortgage Disclosure Act (HMDA) reports.\textsuperscript{50} In 2006 53.7 percent of blacks, 46.6 percent of Hispanics and 17.7 percent of whites received high priced loans. In minority areas (where the population was at least 80 percent non-white) 46.6 percent obtained high-priced loans compared to 21.7 percent in white communities (where racial and ethnic minorities accounted for less than 10 percent of the population). These gaps are reduced but remain sign-
ificant after controlling on various borrower characteristics (for example income, loan amount) and lender type (for example bank, mortgage com-
pany).\textsuperscript{51} Other researchers have also found racial disparities in the share of borrowers who obtained high-priced loans and the cost of those loans after con-
trolling on a range of socio-economic characteristics including credit scores, with racial gaps higher among upper-income than lower-income borrowers.\textsuperscript{52}

Clearly not all subprime loans are predatory, but virtually all predatory loans are in the subprime market. While there is no official definition of a predatory loan, most observers recognize that loans with the following characteristics are likely to be problematic:


\textsuperscript{50} Since 1975 most mortgage lenders have been required by HMDA to report geographic location and other information pertaining to their mortgage lending activity including the disposition of applica-
tions (eg whether they were originated or denied), the type of loan (eg purchase, refinance), and cen-
sus tract in which the property is located. The law has been expanded several times and as of 2004 lenders had to identify high-priced loans where the annual percentage rate exceeded that for Treasury securities of comparable maturities by three percentage points for first lien loans and five percentage points for second lien loans. See RB Avery, GB Canner and R Cook, ‘New Information Reported Under HMDA and Its Application in Fair Lending Enforcement’ (2005) 91 \textit{Federal Reserve Bulletin} 344–94.


\textsuperscript{52} National Community Reinvestment Coalition, \textit{Income is No Shield Against Racial Differences in Lending} (Washington, DC, National Community Reinvestment Coalition, 2007b); DG Bocian, KS Ernst and W Li, ‘Unfair Lending: The Effect of Race and Ethnicity on the Price of Subprime Mortgages’ (Durham, NC, Center for Responsible Lending, 2006); Joint Center for Housing Studies of Harvard University, ‘Credit, Capital and Communities: The Implications of the Changing Mortgage Banking Industry for Community Based Organizations’ (2004) Cambridge, MA: Joint Center for Housing Studies of Harvard University.
—interest rates and fees that far exceed the risk posed by the borrower;
—loans with low initial ‘teaser’ rates that adjust rapidly upward within two or three years;
—high pre-payment penalties;
—loans based on the value of the property with little regard for the borrower’s income and, therefore, ability to repay;
—loan flipping whereby a loan is frequently refinanced, generating fees for the lender but no financial benefit for the borrower;
—high balloon payments;
—negative amortization.

This list is not meant to be exhaustive. But it indicates some of the types of characteristics of loans that have been marketed aggressively to relatively less sophisticated borrowers.

News reports, community advocacy, research, enforcement activity, and policy initiatives have all increased dramatically in recent years. The costs of predatory lending can be severe. In the worst case scenario, families lose their home and their life savings that went into purchasing the home. Short of such a cataclysmic event, predatory lending costs families money they can hardly afford. According to one estimate, predatory mortgage lending costs US families $9.1 billion each year. And the costs are not restricted to unfortunate individual borrowers. Many spill over into the neighborhood and metropolitan area. Subprime lending is concentrated in communities with high unemployment rates and declining housing values, no doubt constituting both a cause and an effect of those neighborhood characteristics. Econometric research has found that the recent rise in subprime lending is associated with higher foreclosure rates which in turn lead to higher crime rates, reduced property values, and, consequently, lower tax revenues. To illustrate, the 3,750 foreclosures that occurred in Chicago in 1997 and 1998 reduced property values by over $598 million, an average of $159,000 per foreclosure.


With the leveling off of housing prices in recent years, default rates are rising and the industry itself, and the economy generally, are starting to pay a price. The Federal Reserve reported that 2.11 percent of residential mortgage loans held by banks were delinquent at the end of 2006, the highest rate since 2002 and at least twice as high as just one year earlier. Several small lenders have failed and large investors are shying away from investments backed by subprime loans. The explosive subprime mortgage market turned many mortgage bankers and brokers into millionaires seemingly overnight, as the technology boom did for dot-com programmers in the 1990s and leveraged buyouts did for many Wall Street bankers a decade earlier. When the Dow (an index for stock values in the US) lost more than 400 points one day and over 200 points a couple of weeks later in March 2007, and lost over 800 points that summer, at least a portion of that loss was attributable to growing problems in the subprime mortgage industry. Another drop of over 200 points in November created new worries that troubles in the subprime market would continue to drive down the stock market and the economy generally. But even these macroeconomic effects are harshest in depressed communities, particularly the Gulf Coast and industrial Midwest. Subprime foreclosure rates in the fourth quarter of 2006 ranged from less than 3 percent in Washington DC, Maryland, and Virginia, to over 7 percent in Mississippi and over 9 percent in Indiana, Michigan, and Ohio.

Borrowers and their communities are taking great risks and paying substantial costs from recent developments in the mortgage market. That is not as true for the industry. Originators can charge higher rates and fees, thus building higher risk into their business plans Most loans are sold in the secondary market, then packaged as securities and sold to investors. Some lenders, particularly in the subprime markets, have closed their doors. But the risks in home mortgages are spread across many investors. Again, when priced appropriately, originators and investors have profited from the proliferation of mortgage loans, as many households and their neighbors have suffered. These dynamics, of course, reflect and reinforce broader economic inequalities.

Perhaps the most heated debate is over what, if anything, should be done about the emerging two-tiered financial services industry and uneven develop-

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ment generally. That debate, in turn, reflects competing explanations for underlying causes of those trajectories of inequality.

V. PAST, PRESENT AND FUTURE POLICY

An individualistic bias has long dominated discussions of inequality in the US.62 A widespread assumption is that voluntary choices made by individuals in competitive markets account for who gets what and why. But this perspective ignores the critical role of a range of public policies and institutionalized private practices that frame the context in which individual choices are made and which give rise to the inequalities noted above.

Economic inequalities, particularly those associated with the labor market, are conventionally explained in terms of human capital theory. That is, those with the most education, skills, experience, and social capital will receive the highest wages with the best benefits packages. The competitive forces of the market place, from this perspective, will minimize any racial and ethnic discrimination since any employer who pays whites more for a given level of human capital will soon be forced out of business.63 Housing decisions, it is argued, reflect individual preferences limited by economic capacity. Families ‘vote with their feet’ by moving to those neighborhoods that offer them the most favorable package of amenities that they can afford.64 Where racial disparities persist today, those inequalities reflect largely choices that minorities have made, often poor choices that reflect the absence of a work ethic, a commitment to a ‘victim-focused identity,’ and a general rejection of mainstream values.65 As John McWhorter has argued, ‘the black community today is the main obstacle to achieving the full integration our Civil Rights leaders sought.’66

But this individualistic bias ignores a range of structural forces that shape the distribution of valued goods and services.67 In the labor market they include the

role of unions which generally provide higher wages and more comprehensive benefits for their members than similarly qualified non-union workers obtain, variations in state minimum wage laws, the presence or absence of living wage requirements, and unevenness in the enforcement of labor laws all contribute to economic inequality. Economic restructuring (especially the shift in employment from manufacturing to both high-wage business services and low-wage personal services) has also contributed to the ‘surge in inequality.’ Old-fashioned racial discrimination persists as a central feature of US labor markets. One recent study found that white job applicants with a felony on their record were far more successful in obtaining jobs than equally or better qualified African Americans with no criminal record.

In the housing market, far more than individual choice is also involved, particularly in terms of the segregated patterns of US cities. Intimidation and violence by neighborhood ‘improvement’ societies, explicitly discriminatory policies that virtually excluded non-whites from FHA and other government-insured loan programs from the 1930s into the 1960s, refusal of real estate and rental agents to provide similar levels of service to white and non-white clients, the steering by agents of real estate buyers to communities based on their race and that of the neighborhoods, redlining by financial institutions, concentration of public housing complexes in inner city ghettos and barrios, and exclusionary zoning ordinances in most suburbs are among the policies and practices that have shaped the patterns of concentrated poverty, segregation, and sprawl in American metropolitan areas.

If public policies and private practices have shaped the uneven development of metropolitan areas, including the uneven access to financial services, then alternative policies and practices can ameliorate those patterns. Since late 2008 a series of multi-billion dollar bailout or rescue initiatives were launched in, so far, failed efforts to stabilize financial institutions or stem growing economic crises. But other largely unexplored options should be considered. The following pages explore specific proposals to ameliorate various trajectories of inequality and provide for more equitable access to financial services.

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Several politically feasible tools are available to respond to the overall surge in inequality. For example, the federal minimum wage should be indexed to take into consideration cost of living increases as several states have done.\(^7\) It had stood at $5.15 since 1997; scheduled raises were enacted in May 2007 that will bring it to $7.25 in 2009. Because of cost of living increases the purchasing power of the federal minimum wage had deteriorated by 20 percent since 1997, reaching its lowest inflation-adjusted level since 1955.\(^7\) Living wage ordinances mandating even higher wages, generally $8 to $10 per hour, have been enacted in more than 100 localities. The objective of living wage requirements is to enable families to live independently of welfare and related public support payments. All units of government could easily incorporate such requirements in any work done by government contractors or those who receive economic development subsidies.\(^7\) The Earned Income Tax Credit could be expanded. This initiative provides money for those working but making below poverty wages, consequently lifting many working families out of poverty. This program has widespread appeal across the political spectrum because it rewards work and helps lift many who are working out of the poverty conditions that their low wages would leave them in without this credit.\(^7\) A more provocative proposal has been offered by former Minnesota Rep Martin Sabo, whose Income Equity Act would deny corporations tax deductions on any executive compensation exceeding 25 times the pay of the firm’s lowest-paid workers.\(^7\)

Enacting the Employee Free Choice Act, providing a national union dues check-off system, would strengthen the role of unions in the US and their positive impact on wage inequality.\(^7\) This bill would allow workers to join a union and direct their dues to the appropriate union after 50 percent of all employees have signed a card indicating their desire to do so. This process would replace the current requirement for an election that often occurs in an intimidating environment where management warns workers of potentially adverse consequences if a union should be certified. Such a process would make it easier for

those who want union representation to have that protection. Some but not all states do allow this. Making it a national law would bring the US into conformity with several other industrialized countries that permit this option.\(^7\) The share of the work force that is unionized has declined in recent years but this reflects primarily stepped up anti-union activity by employers and the failure of the Federal government to enforce the National Labor Relations Act as intended when it was enacted.\(^7\) In fact, in 2005 more than half of all non-union workers would have voted for union representation if they had the opportunity, up from approximately one-third of such workers in the mid-1990s.\(^8\)

Expansion of several housing and land use policies would also reduce various trajectories of inequality. Inclusionary zoning laws that require developers to set aside a specific share of housing units to meet affordable housing objectives have now been implemented in dozens of cities. Tax-based revenue sharing, whereby a portion of the increasing property tax revenues in prosperous neighborhoods is used to invest in housing and other community development initiatives in distressed areas, has been implemented in Minnesota.\(^8\) Mobility programs have enabled thousands of families to leave ghettos and barrios for more prosperous outlying urban and suburban communities where they found safer communities, better schools, and better job prospects.\(^8\)

In addition to policies aimed at ameliorating economic inequality generally, other policies directed specifically at financial service providers are also required. More comprehensive financial literacy programs for consumers is widely recognized as a step in this direction.\(^8\) Community development finance institutions (CDFIs), which receive incentives including grants and other assistance from the federal government to provide financial services to traditionally underserved neighborhoods, appear to be doing just that. CDFIs include community development banks, community development credit unions,  


microenterprise lenders, community development corporations and community development venture capital funds. Again, such initiatives should be expanded.

But more aggressive efforts to redirect the activities of mainstream financial institutions is essential to complement the efforts of alternative services and what consumers can accomplish via education. The advent of electronic banking makes it much more cost-effective for mainstream institutions to reach out to the unbanked and basically out-compete fringe bankers. Carefully targeted financial incentives would encourage more banks to do so.84

The Community Reinvestment Act (CRA), which requires mortgage lenders to ascertain and be responsive to the credit needs of their entire service areas including low- and moderate-income communities, should be strengthened, rather than weakened as has been the case in recent years. Currently the statute only applies to federally chartered depository institutions (for example, banks and thrifts), but most of the subprime lending is originated by independent mortgage bankers and brokers not covered by the CRA. This statute should be expanded to cover those lenders along with credit unions, insurers, and others engaged in mortgage lending. The Community Reinvestment Modernization Act, introduced by Eddie Bernice Johnson (D-Texas) would accomplish this objective.85 The Home Mortgage Disclosure Act (HMDA), which facilitates enforcement of CRA, should be expanded as well. It should require pricing information on all loans, not just so-called high-priced loans, along with information on the credit rating of applicants, and characteristics of the property (square feet, number of rooms), to permit more comprehensive analyses of differences in denial rates and services to various groups and communities.86

A strong national predatory lending law should be enacted. As of spring 2007, 36 states and the District of Columbia have such laws, leaving consumers in other states less protected.87 While there is variation across these statutes they generally require lenders to charge interest rates and fees that are commensurate with the risk borrowers pose, limit prepayment penalties, verify income of

borrowers to maximize the likelihood they will be able to afford the loan, offer products that offer a financial benefit to borrowers, and take other steps to assure access to credit on fair and equitable grounds. No doubt, more aggressive enforcement of fair housing and fair lending laws would also increase fair access to credit and banking services generally.\(^{88}\)

Under the Home Ownership Equity Protection Act the Federal Reserve Board could and should issue regulations that would be responsive to many of the problematic practices that are taking place in today’s mortgage market. But federal legislation may well be required for a more comprehensive remedy that would apply to all products and protect all borrowers. Lenders should be required to document a borrower’s ability to repay and underwrite loan applications accordingly. They should escrow for taxes and insurance so borrowers are not deceived by what appears to be low monthly payments, only to be hit by unaffordable property tax and homeowner’s insurance bills after the loan is closed. Prepayment penalties that trap borrowers into high-cost loans should be prohibited. Lenders should be liable for the practices of the brokers with whom they do business. In addition, investors who purchase predatory loans, thus providing material incentives for such lending, should be liable for these abusive practices. Several bills have, in fact, been introduced in Congress that would address these and related issues.\(^{89}\)

A more fundamental change would be to place a duty of suitability on lenders requiring them to recommend loan products that are most appropriate for borrowers given their financial situation (reducing the likelihood of default and foreclosure) similar to rules that currently apply to securities brokers and financial planners. This, in essence, would shift at least some of the burden from individual consumers and complainants to lenders themselves to assure compliance with fair lending and anti-predatory lending rules. Some states are already moving in this direction by prohibiting those loan products and services that do not provide a net tangible benefit to the borrowers. Again, pending legislative proposals in Congress would address these issues.\(^{90}\)

Ideas alone, of course, do not translate into action. Identifying appropriate political actors and developing a political strategy for implementing progressive ideas is equally if not more challenging as developing a policy agenda. Generally this requires mounting an organizing effort to encourage (if not require) those with the power and authority to act to do so. In the area of financial services,

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many of the problematic practices have been outlawed, but the regulators are often as much a problem as the financial service providers themselves.\(^91\)

In recent years several community groups and a number of national membership organizations and networks have effectively challenged and changed the behavior of the financial services industry. Groups like the Association of Community Organizations for Reform Now (ACORN), the National Community Reinvestment Coalition (NCRC), the National Training and Information Center (NTIC), the National Fair Housing Alliance (NFHA) and others have secured access to financial services for markets that have long been underserved or exploited by the industry.\(^92\) For example, ACORN estimated that between 1995 and 2004 it generated more than $6 billion for low-income communities through its CRA organizing efforts and another $6 billion from its anti-predatory lending campaigns. Adding its work to create living wage ordinances, develop affordable housing, and reform various public services ACORN pegs its return to low-income communities at more than $15 billion.\(^93\) Using leverage provided by the federal Community Reinvestment Act (basically a federal ban on redlining) NCRC estimates that more than $4.7 trillion in new loans have been secured for low-income and minority markets since the statute was enacted in 1977 largely in response to community organizing efforts.\(^94\) Under authority provided by the federal Fair Housing Act, the National Fair Housing Alliance estimated that non-profit advocacy groups generated $225 million for plaintiffs since 1990.\(^95\)

But future advances will likely require even stronger coalitions. And there are a number of logical partners, some of whom are already working with these community organizations. Organized labor, church groups, members of the local media, some elected officials (for example, mayors whose cities are losing tax revenues from predatory lending), foundations, and many others can collaborate in effective efforts to extend recent successes in democratizing access to financial services.\(^96\)

The credit squeeze and related financial crises that many families (poor, working-class and even middle-income) face are inextricably linked to broader


\(^{94}\) National Community Reinvestment Coalition, ‘30th Anniversary: The Community Reinvestment Act’ (Washington, DC, National Community Reinvestment Coalition, 2007); EB Johnson and L Gutierrez, Dear Colleague letter, ‘Support the Community Reinvestment Act (CRA) Modernization Act in the 111th Congress,’ 19 November 2008; e-mail message from J Taylor to NCRC Listserv (ncrclist@ncrc.org), 19 November 2008.

\(^{95}\) National Fair Housing Alliance, ‘$225,000,000 and Counting’ (Washington, DC, National Fair Housing Alliance, 2006).

forces of uneven development that have taken hold since Thurow noted the surge in inequality. The public policies and private practices that have generated these outcomes are no secret. Neither are at least some of the remedies. Over 100 years ago Frederick Douglass provided what remains one of the critical lessons for today when he stated:

If there is no struggle, there is no progress.
Those who profess to favor freedom and yet deprecate agitation
Are men who want crops without plowing the ground.
They want rain without thunder and lightning.
They want the ocean without the awful roar of its waters.
Power concedes nothing without a demand.
It never did, and it never will.

August 4, 1857, West India Emancipation,
Speech delivered at Canandaigua, New York.97

97 JW Blassingame (ed), The Frederick Douglass Papers (New Haven, Yale University Press, 1985) 204.
The Political Economy of Consumer Credit Securitization: Comparing Predatory Lending in Home Finance in the US, UK, Germany and Japan

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The United States’ home mortgage market is in a state of upheaval. The American media is currently saturated with troubling news of foreclosure and financial desperation faced by families and neighborhoods all around the country.¹ Nationally, over two million American families are in the process of losing their homes to foreclosure—economic refugees rivaling in numbers what might be produced by a small civil war.² One rating agency predicts that between 40 and 50 percent of all subprime mortgages originated since 2006 will end in foreclosure.³ Ethnic minority families in particular are disproportionately losing their homes.⁴ As the volume of foreclosures has increased, it has put downward pressure on home prices, contributing to the first decline in the national median price for previously owned homes since the Great Depression of the 1930s.⁵ Some cities in the industrial mid-west have been particularly hard hit, with foreclosures leaving thousands of homes abandoned; currently, foreclosure and other economic pressures have left an estimated 10,000 of Cleveland, Ohio’s 84,000 single-family homes sitting vacant and rapidly deteriorating into urban

* Special thanks to Pedro Allende and Robbie Alipour for excellent research assistance in the preparation of this Chapter.


² Editorial, ‘Coming to Grips with the Subprime Meltdown: California Should Follow the Lead of Other States With Stronger Mortgage Protections’, Sacramento Bee (1 April 2007) E6.


blight.6 After years of record profits, the once reputable investment bank Bear
Sterns collapsed from subprime mortgage losses, inducing the Federal Reserve
Board of Governors to orchestrate a transfer of the firm’s assets to another invest-
ment bank and its potential liabilities to the US treasury.7 Congress has been con-
ducting hearings demanding answers from the mortgage industry and from
federal banking regulators. Scholars, pundits, politicians, and bankers have all
cast about looking for an explanation. The most common account references the
collapse of a ‘bubble’ in housing prices. But, more thoughtful commentators have
asked how the bubble formed in the first place, and why a collapse in housing
prices has been associated with the inability of consumers to make monthly pay-
ments on homes not listed for sale.

Several American legal scholars, including Pat McCoy, Kathleen Engle, Kurt
Eggert, Julia Patterson-Forrester and I, have explored how the secondary mar-
ket in assignment of home mortgages influences the origination practices and
underwriting standards of home mortgage lenders. In this Chapter I will suggest
that the interaction of American law and the structured finance of home mort-
gage origination—often called securitization—is one of the most important
causes of residential mortgage overindebtedness. This essay builds on my previ-
ous research on structured finance of predatory home mortgages by comparing
the law and business practices of securitization in the United States to that found
in three influential countries from around the world: the United Kingdom,
Germany, and Japan. Moreover, this Chapter inquires whether the recent US
meltdown in securitized home mortgages may hold lessons for international
legal and business scholars. Indeed, this discussion is both timely and important
because international financiers continue to advocate the use of American-style
securitization in commercial and residential lending markets around the
world. A comparative discussion of home mortgage securitization may paint a
cautionary picture with lessons on how to avoid the instability and tragedies
currently occurring in the United States.

Accordingly, this essay first provides a brief introduction to the business prac-
tices of, and law governing, residential mortgage securitization in the United
States. Part II surveys the growing use of securitization in markets around the
world, focusing on the United Kingdom, Germany, and Japan. Part III inquires
whether securitization may create structural economic incentives that promote
consumer overindebtedness as well as predatory lending. Part IV looks at the
political economy of residential mortgage securitization and argues that securi-
tization will tend to empower opponents of consumer protection law and then
offers tentative policy recommendations. Part V provides concluding remarks.

(‘Many of the houses are filled with smelly trash and mattresses used by vagrants. They have been
stripped of aluminum siding, appliances, pipes and anything else that scavengers can sell to scrap
dealers.’).
I. SUBPRIME HOME MORTGAGE SECURITIZATION IN THE UNITED STATES

Securitization, also referred to as structured finance, is a financing technique that allows capital markets to take direct ownership of revenue streams by pooling assets, and then reselling them to investors. In countries with law amenable to structured finance, virtually any income-producing asset can be securitized. In the United States securitization is used to finance everything from physician and hospital accounts, oil exploration, lawsuit settlement proceeds, entire business ventures, music royalties, or even baseball stadiums. But, among the most commonly securitized assets both world-wide and in the United States are consumer loans, especially residential home mortgages.

The business structure of residential mortgage securitization in the United States has evolved into a complex web of relationships between different business entities that provide a variety of lending and investment-related services. In the US, there are two basic home mortgage securitization markets: one public (or at least quasi-public) and the other private. Generally speaking, most of the public home mortgage securitization market runs through one of two ‘Government Sponsored Enterprises’ (GSEs) created by Congress. These companies, Fannie Mae and Freddie Mac, purchase home mortgages that meet relatively strict underwriting guidelines from private mortgage loan originators. The status of Fannie Mae and Freddie Mac is somewhat ambiguous since Congress has not passed legislation explicitly guaranteeing payment on bonds or securities issued by the GSEs. Yet, the capital markets generally regard the two companies as ‘too big to fail,’ treating the debt as virtually guaranteed by the US government on the theory that Congress would not allow the companies to collapse. Fannie Mae and Freddie Mac hold some mortgages in their own portfolios, but many others they pool into investment vehicles and sell as securities to investors. The enormous volume of loans securitized by Fannie and Freddie give the companies both economies of scale and risk-spreading advantages that most private companies cannot match. Moreover, because of the implicit federal guarantee on Fannie and Freddie loans, the GSEs can find investors for their securities without incurring transaction costs from rating agencies or credit enhancements.

10 Credit enhancements are agreements that shift risks away from investors. Commonly they take the form of third party guarantees from an insurance company on losses from mortgage defaults and
On the other hand, the GSEs have been reluctant to offer high loan-to-value loans and have been unwilling to purchase loans made to borrowers with questionable credit histories. Loans sold into capital markets from these public sources tend to be relatively homogenous, fifteen- or thirty-year mortgages, frequently with fixed interest rates, and no prepayment penalties. Fannie and Freddie refuse to purchase loans from private mortgage originators unless they use standardized contracts with terms generally seen as fair to both parties. Both GSEs have strict automated underwriting standards, use widely accepted financial models, require standardized documentation, and pay similar prices for all the loans they purchase. As a result, Fannie and Freddie tend to exert a stabilizing force on the ‘prime’ mortgage market, acting as gatekeepers that weed out loans with predatory terms or risky underwriting. Some commentators also argue that the GSEs’ mortgage pools tend to combine lower and some moderate risk borrowers together, with the same loan pricing, creating a modest subsidy to some moderate risk borrowers. Mortgages packaged by Fannie Mae and Freddie Mac have performed relatively well throughout the recent mortgage market problems in the United States.

In contrast, the private secondary home mortgage market lacks uniform underwriting guidelines. This has freed originators to make loans with a great variety of pricing and prepayment terms, and also to reach much deeper into higher risk borrower populations. In recent years, the US ‘subprime’ market, which generally refers to loans that do not qualify for assignment to the GSEs, has relied heavily on loans with introductory teaser interest rates that adjust upwards, high prepayment penalties, and high (as well as misleading) closing costs. A significant percentage of subprime borrowers—as much as a third by one estimate—actually qualify for prime mortgages but have nevertheless been steered or enticed into the private subprime market. The structure of the secondary market for subprime mortgages reflects the variety in origination practices. Factors such as the type of assets involved, the anticipated preferences of potential investors, the size and growth plans of the originator involved, and the liability risks associated with the transaction can all lead to different securitization strategies. Nevertheless, Figure 2.1 provides a schematic that attempts to


13 J Tyson, ‘2 Mortgage Lenders are Heroes After Subprime Fallout, Int’l Herald Tribune’ (Paris, 6 June 2007) 16 (detailing success of Fannie Mae and Freddie Mac in weathering housing price downturn).

illustrate the flow of capital and information in a typical American subprime home mortgage lending securitization conduit.

A typical subprime home mortgage securitization conduit begins with a mortgage broker—essentially a loan salesperson—identifying a homeowner willing to pledge a home in exchange for a loan. American brokers use a variety of marketing techniques including direct mail, telephone solicitation, door-to-door solicitation, email, and radio, Internet, or television advertising. Along with the broker, a mortgage lending company obtains information on the consumer from one or more of the three national credit-reporting agencies.15 Once the originator is satisfied that the borrower meets its underwriting guidelines, the

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15 The United States has an active market in personal credit history information. There are three large companies that attempt to maintain comprehensive credit histories of every adult American. These companies are Equifax, Experian, and Trans Union. J Carton-Good, All About Mortgages: Insider Tips to Finance or Refinance Your Home 3rd edn (New York, Dearborn Trade Publishing, 2004) 33–5.
loan is funded at a real estate closing meeting. Then, in a typical conduit, the originator will quickly transfer the loan to a subsidiary of an investment banking firm.\textsuperscript{16} This subsidiary, which is alternatively called the securitization sponsor, or seller, then transfers the loan and hundreds of others like it into a pool of loans.\textsuperscript{17} This pool of loans will become a business entity, called a special purpose vehicle (SPV). The SPV can take the legal identity of a corporation, a partnership, or a limited liability company, but most often is a trust.\textsuperscript{18} Aside from the mortgages, the SPV has no other assets, employees, or function beyond the act of owning the loans. Under the agreement transferring the loans into the pool, the SPV agrees to sell pieces of itself to investors. In a typical transaction, an underwriter purchases all the ‘securities’—here meaning derivative income streams drawn from payments on the underlying mortgages—issued by the pool. Usually employing one or more placement agents who work on commission, the underwriter then sells securities to a variety of investors with different portfolio needs. In designing the SPV and its investment tranches, the seller typically works closely with one of three credit rating companies that in exchange for a fee rate the credit risk of each tranche.\textsuperscript{19} A ‘tranche’ is a specified part of the income generated by monthly payments made on loans included in the pool of mortgages. The credit rating agency investigates the credit risk of the underlying mortgages as well as the risks posed from pooling the mortgages together. Credit ratings on each tranche are essential, since they obviate the need for each individual investor to do due diligence on the underlying mortgages in the pool.\textsuperscript{20} The rating agency will typically require some form of credit enhancement on some tranches to assign them higher investment ratings.

The seller also arranges to sell the rights to service the loan pool to a company which will correspond with consumers, receive monthly payments, monitor collateral, and when necessary foreclose on homes. Sometimes the originator retains servicing rights, which has the advantage of maintaining a business relationship with homeowners. But often servicing is done by a company specializing in this activity. Increasingly, American pooling and servicing agreements allow for several different servicing companies with different debt collection roles. A master servicer may have management responsibility for the entire loan pool. The master servicer may subcontract to subservicers with a loan type or


\textsuperscript{17} Sometimes the loan will be held in an SPV that is a wholly owned subsidiary of the originator or the underwriter while awaiting assignment into an independent SPV that will issue securities. See, eg, S Schwarcz, ‘The Alchemy of Asset Securitization’ (1994) 1 Stanford Journal of Law Business and Finance 133, 142 (describing advantages of ‘two tier’ securitization conduit structures).

\textsuperscript{18} C Hill, ‘Securitization: A Low-Cost Sweetener for Lemons’ (1996) 74 Washington University Law Quarterly 1061, 1067 n 25, 1098 n 162.


\textsuperscript{20} Schwarcz, ‘The Alchemy of Asset Securitization’, above n 17, at 136.
geographic specialty. The pooling and servicing agreement may also allow for a special servicer that focuses exclusively on loans that fall into default or have some other characteristics making repayment unlikely. Some servicing agreements require servicers to purchase subordinated tranches issued from the mortgage pool in order to preserve the incentive to aggressively collect on the loans. Servicing rights also change hands often, in some cases several times a year for the same loan. If, for instance, a servicing company is not meeting collection goals or is charging the trust too much, the trustee may contract with a new servicer. In addition to one or more servicers, many American securitization structures use a document custodian, most frequently a company called Mortgage Electronic Registration System, Inc. (MERS), to record the mortgage with a county recording system and to track ownership and servicing rights for the pool.

In the United States the most important legal question in securitizing home mortgages is whether the SPV acquired bankruptcy remote assets through a ‘true sale.’ The loans held by an SPV are bankruptcy remote when the insolvency of loan originators cannot affect the legal status of the securitized loans. To induce investment in the SPV’s securities, rating agencies and investors must be assured that the insolvency of loan originators—a frequent occurrence in the US—will not cause the SPV’s assets to be treated as part of the originator’s estate. Otherwise the securities will be unmarketable. A rather complex and evolving jurisprudence has developed in the US on the finer points of when a sale is a ‘true sale,’ making the assets bankruptcy remote. Bankruptcy judges must weigh the claims of the originator’s creditors, sometimes including fraud victims, against the rights of the SPV and its investors.

II. CONSUMER CREDIT SECURITIZATION IN COMPARATIVE PERSPECTIVE

Securitization deals that cross national borders create both legal and monetary challenges for all of the parties involved. Legally, cross-border securitization is now generally governed by the United Nations Commission on International
Trade Law’s Convention on the Assignment of Receivables in International Trade.\textsuperscript{26} The goal of the treaty was to promote commerce by increasing the availability of capital through international capital market investment. While a complete account of the treaty is beyond the scope of this Chapter, its core legislative compromise is to defer to the local priority laws of the jurisdiction where the party assigning receivables is located, rather than the jurisdiction of debtors obligated to pay or of investors entitled to receive the obligations in question. While this provision does nothing to clarify the local laws of the assignor’s state, it does give the parties some certainty in knowing what laws will apply ahead of time.

Even where choice-of-law provisions are clear, cross-border securitization deals must address the risks posed by fluctuation in the value of currency. This is because investors may be investing in loans or other assets that are payable in the currency of a different country. This makes the investment in asset-backed securities much more speculative because changes in currency exchange rates are so difficult to predict. Without a mechanism for separating currency risk from the credit risk on the assets themselves, a large investment in home mortgage loan securities could be functionally wiped out by macroeconomic changes unrelated to the loans themselves. Securitizers generally address this risk by hedging against currency fluctuation with a ‘swap counterparty.’\textsuperscript{27} This third party agrees, for a fee, to buy at some point in the future a yet-to-be-determined amount of the currency of the investors’ countries. In a typical securitization currency hedge, the parties agree in advance on a set exchange rate for the two currencies involved. Then, on scheduled settlement dates, investors can call on the swap counterparty to deliver enough value to offset any losses incurred due to unfavorable shifts in currency exchange rates.\textsuperscript{28} The credit rating of the securities will then depend in part on the credit risk of the swap counterparty. Sometimes the swap counterparty’s promise will be enhanced with a third-party guarantee or a cash collateral account held in trust (both of which create additional transaction costs). Of course, it should go without saying that in securities composed of loans payable in highly unstable currencies it may be difficult or impossible to find a swap counterparty willing to absorb the currency risk.

Given these additional hurdles in securitizing assets across international borders, it should not be surprising to find that in many jurisdictions around the


\textsuperscript{27} S Schwarcz, B Markell, and L Broome, Securitization, Structured Finance, and Capital Markets (Newark, Lexis/Nexis, 2004) 196.

\textsuperscript{28} J Marshall and K Kapner, The Swaps Market 32 2nd edn (Miami, Kolb Publishing Co, 1993). The building societies were funded by retail deposits, much as the American savings and loan institutions in the same period.
world purely domestic securitization is more prevalent than cross-border transactions. The remainder of this Part summarizes the business and legal climate for consumer credit, including especially residential mortgage loan securitization, in the United Kingdom, Germany, and Japan.

A. United Kingdom

Along with the United States, the United Kingdom’s securitization market is the oldest and most developed in the world. In the 1980s, securitization first allowed competitors to challenge the domination of building societies in the UK real estate mortgage market.29 With strong political allies, including the Bank of England, regulatory, accounting, and legal hurdles to securitization have been cleared away.30 The result has been steady growth in both the volume and variety of securitized assets.

As is true elsewhere, in the UK the key legal issue for investors in mortgage-backed securities is whether ‘the mortgage . . . [originator] has no recourse to an institution that sells the mortgages on if it runs into problems.’31 Unlike securitization in the United States, where a true sale is generally recognized as a prerequisite to securitization, some structured finance conduits in the UK rely on the originator of the assets merely granting a security interest to the SPV that later issues securities. This structure has proven especially useful in the securitizations of entire business ventures. Capital markets have accepted this legal form because UK law does not prevent the SPV’s seizure of the securitized assets in the event of the originator’s insolvency.

Although UK financiers have produced many creative commercial and consumer securitization structures, the vast majority of securitizations in the country have involved residential mortgages, which tend to show similar structural patterns to those in the US. Also similar to the US, the UK has active securitization markets in both prime and subprime home mortgages. While mortgages in many European countries are originated exclusively through bank branches, in the UK intermediary mortgage brokers similar to those in the United States are rapidly gaining market share.32 These brokers have increasingly used non-standardized underwriting and offered a variety of different repayment terms.33

31 Ibid, 250.
32 European countries where mortgages are originated primarily through bank branches include ‘Denmark, Germany, Spain, France, Italy, Austria, Poland, and Portugal.’ Commission (EC) Mortgage Funding Expert Group, ‘Report of the Mortgage Funding Expert Group’ 6 (Brussels) 22 December 2006 (hereinafter Mortgage Funding Expert Group).
33 Ibid.
American subprime mortgage companies have had their sights on the UK market for at least a decade. For example, as early as 1998 Ocwen Financial Corporation, a south-Florida subprime mortgage company, made its debut in the UK by issuing what was at the time the UK’s largest subprime securitization ever.\(^{34}\) In the United States, Ocwen has been dogged by consistent allegations of predatory lending and servicing practices.\(^{35}\) In one Texas case, a jury awarded a homeowner over $11 million in punitive damages for Ocwen’s intentional unfair and deceptive mortgage servicing behavior. In the trial, a former Ocwen employee testified that the company offered incentives to its employees for moving homes into foreclosure even when the borrower had sufficient equity in the home to refinance into a more affordable loan.\(^{36}\) Apparently the jury concluded that Ocwen was forcing homeowners into foreclosure because of the opportunity to generate fees from the foreclosure process itself. It is unclear to what extent Ocwen and other American companies engage in similar practices in the United Kingdom.

B. Germany

Germany has had an active secondary market in home mortgages for well over 200 years.\(^{37}\) German mortgage banks fund themselves by issuing mortgage backed bonds, or ‘covered bonds’, called Pfandbriefe. Unlike American and UK securitized mortgages, Pfandbriefe do not involve a true sale of the mortgages to an SPV. Rather the mortgages stay on the balance sheet of the originating bank. But, Pfandbrief investors have a priority vis-a-vis other mortgage bank creditors in the unlikely event that a German bank were to become insolvent.\(^{38}\) In practice, Pfandbriefe trade at low fixed interest rates and with excellent liquidity because of close bank oversight and the privileged legal status of Pfandbrief investors with respect to an originator’s competing creditors. In order to issue

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\(^{36}\) T Cornwell, ‘Ocwen Faces $11.5M Verdict’, National Mortgage News (New York, 5 December 2005) 30 (‘A county jury here has smashed Ocwen Federal Bank with an $11.5 million verdict based on alleged predatory servicing practices involving a single home-equity loan customer’).


Pfandbriefe, the originator must submit to close government scrutiny and regulation of the underlying loans. Unlike the US and the UK markets, where lenders make loans (or combinations of loans) with loan-to-value ratios of as high as 110 percent, mortgages in the relatively straight-laced German Pfandbrief market have a much lower maximum loan-to-value ratio. Moreover, German mortgage banks are protected from declining prevailing market interest rates because consumers may not prepay their mortgages in Germany. This eliminates one of the most difficult and complex risk factors borne by American lenders.\(^{39}\)

Despite both its size (Germany is the largest credit market in Europe) and its long tradition of a secondary mortgage market, Germany’s use of asset-backed securitization is still relatively undeveloped.\(^{40}\) A handful of German companies began securitizing assets in the early 1990s, but the financing technique was slow to catch on due in part to banking regulatory opposition.\(^{41}\) Germany did not adopt specific legislation authorizing securitization, instead relying on generally applicable commercial law principles. Moreover, since German civil law lacks a legal entity comparable to the common law trusts generally used as SPVs in the US and the UK, German creditors have not had a business entity naturally suited to passive ownership of assets intended for securitization. Furthermore, perhaps owing in part to this tradition, in 1999 German authorities applied the German trade tax to SPVs, which essentially prevented profitable securitization through a bankruptcy remote entity.\(^{42}\) For the next several years German financial institutions circumvented the tax problems associated with SPVs either by setting up cross-border transactions with foreign SPVs outside German tax jurisdiction or by using domestic synthetic securitization structures. In typical German synthetic securitization transactions, an originator, usually a bank, will sell credit risk derivatives that reference a pool of assets instead of actually transferring legal title to an investment vehicle.\(^{43}\) This arrangement avoids the cross-border transaction costs and still allows the parties to structure a stream of income into tranches with different credit ratings. But, because the assets are not actually sold, the originator retains the loans on its own books tying up regulatory capital. In Germany, as in other countries, banking regulators insist that banks retain sufficient reserves to cover possible defaults on loans owing to them that might otherwise cause banks to be unable to cover their deposit exposure. These reserve requirements are an important factor affecting a bank’s cost of funds.


\(^{41}\) Aleknaite, above n 38, at 209.

\(^{42}\) NK Young and J Spencer, ‘German True Sale Initiative: The Rebirth of True Sale Securitization’ (Fall 2004) 6 CMBS World 33.

Moreover, because the assets are still owned by the originator, the ratings given to synthetic tranches will still be influenced by the credit rating of the originator—defeating one of the primary advantages of true sale securitizations.

Nevertheless, there are some indications that the tax and accounting hurdles facing German securitization may be eroding. In 2003, after extensive negotiations with banking authorities, a group of German banks joined together to create the ‘True Sale Initiative’ with the intention of reviving true sale securitization in Germany.44 The organizers of the initiative were attempting to facilitate creation of limited liability companies that could act as SPVs without incurring taxes on the SPVs’ revenue. Moreover, the initiative included the creation of a company that serves as a public voice and an advocate for true sale securitization in the country. Also interesting, in 2003 the Reichstag passed legislation establishing that servicers of receivables need not be financial institutions—potentially clearing the way for less capitalized and less regulated companies to become the primary businesses interacting with consumer debtors.45 Although the True Sale Initiative was backed by well-funded companies, only a modest number of securitization deals have been issued on the new platform. Advocates of securitization complain of continuing tax law ambiguities as well as relatively high transaction costs associated with setting up the limited liability company SPVs.

In the long run, a development that may ultimately have more import for German consumers is the European Commission’s continuing deliberations on how to address hurdles to securitization throughout the European Union. In 2006 the Commission formed an Expert Group on Mortgage Credit, tasking it with drawing up a report that describes the funding of residential mortgages in the EU and offering policy recommendations. The Expert Group recently released its findings, which include, by German standards, relatively aggressive overtures in favor of securitization as it is practiced in the US and increasingly in the UK. In terms of general themes, the expert group concluded that mortgage funding policy in the EU should embrace five core values: ‘It should be complete, competitive, efficient, transparent, and stable.’46 The report includes numerous specific recommendations including admonishing the Commission to consider opening up mortgage origination throughout Europe to ‘credit intermediaries,’ non-depository private companies similar to American mortgage brokers. The expert group also argues that consumer mortgage originators and servicers in one part of Europe should have a regulatory ‘passport’ authorizing them to do business in any country within the Union.47 Also interesting is a model of mortgage funding not embraced by the expert group: the experts agreed with an earlier Forum Group in rejecting a pan-European mortgage finance agency

44 Young and Spencer, above n 42, at 35.
45 Aleknaite, above n 38, at 230.
46 Report of the Mortgage Funding Expert Group, above n 32, at 5.
modeled on the US government sponsored enterprises Fannie Mae and Freddie Mac.  

C. Japan

The watershed event in the post-war Japanese mortgage market was the formation of the Government Housing Loan Corporation (GHLC) in 1950. Unlike the government and quasi-government institutions in the US, throughout most of its history the GHLC made direct home mortgage loans to the Japanese public. The GHLC obtained its capital through the Japanese government’s Fiscal Investment and Loan Program (FILP). FILP was a large ‘second budget’ within the Japanese government funded by non-tax revenue, including especially Japanese postal savings bonds used by Japan’s traditionally savings-oriented consumers. GHLC home mortgage pricing was not risk adjusted: borrowers qualified for only one low fixed interest rate. Moreover, the GHLC required relatively conservative underwriting guidelines, such as a rule that borrowers could encumber themselves with payments no higher than 25 percent of their monthly income.

In the 1970s several large banks and securities firms established seven large private consumer-housing finance companies. These companies, called *jusen*, were established with the backing of the Japanese Ministry of Finance. Similar to the savings and loan industry in the US and the building societies in the UK, the *jusen* were initially created to facilitate home mortgages through private lending. But when Japanese banks later entered into the home mortgage lending business as well, many of the *jusen* began to finance commercial real estate. After the stock market decline in 1989, many of the *jusen*’s corporate borrowers defaulted on their loans, exposing the real estate collateral as overvalued and insufficient to cover $80–100 billion of non-performing loans. The *jusen* had been able to conceal their overexposure by inflated and unrealistic appraisals of commercial property as well as ambiguous accounting standards for classifying non-performing loans.

Following the Japanese real estate bubble, the Diet adopted a string of reforms aimed at pulling Japan out of its long malaise, some of which spurred growth in Japanese securitization. In 1992 the Diet passed a law allowing

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50 Green and Wachter, above n 12, at 103.

limited securitization of credit card and consumer lease receivables. In 1996 the Ministry of Finance adopted reforms allowing some financial institutions to create domestic special purpose corporations called yugen kaisha. This business entity had many of the same characteristics as US and UK SPVs inducing further growth in securitization of non-mortgage consumer receivables. In 1998 and again in 2001 the Diet passed legislation attempting to promote greater efficiency throughout the entire government. The 1998 legislation included reform of Japan’s secured credit law simplifying procedures for maintaining perfection of assigned loans. The 2001 legislation attempted to reign in spending in the FILP, including the GLC. That year the Diet approved a five-year plan to dismantle the GHLC by shifting its activities from direct lending to support of securitization of mortgage loans originated by private financial institutions. Ultimately the GHLC was to be converted into an ‘independent administrative agency’ similar to Fannie Mae and Freddie Mac in the US. Japan completed this process in April of 2007, renaming the GHLC the Japan Housing Finance Agency.

Along with increasing public securitization of prime home mortgages, in the last year or two several non-Japanese financial institutions have entered origination alliances with Japanese banks and/or mortgage banks. Similar to the relatively recent entrance of independent mortgage brokers in the UK, these originators are focusing on issuing non-conforming subprime mortgages to customers with questionable credit profiles. Following patterns seen in the US market, these loans have higher, risk-adjusted prices than the traditional Japanese prime loans that continue to carry homogenous pricing irrespective of the borrower’s credit profile. Investment analysts predict that this trend is likely to continue both in Japan and throughout much of East-Asia.

III. THE CONNECTION BETWEEN OVERINDEBTEDNESS AND SECURITIZATION

Advocates of disclosure law, counseling, and financial education tend to see overindebtedness as a function of poor consumer decision making. In contrast,
advocates of generous discharge rules for insolvent debtors tend to see overindebtedness as a function of societal factors beyond debtors’ control such as systemic poverty, unemployment, and (particularly in the US) the cost of medical care.  

Still other commentators point to cultural change, bemoaning a decline in thrift and in stigma associated with insolvency. Less discussed in the academic literature on overindebtedness is the influence of financial and institutional structures on the performance of the consumer lending market. This section argues that throughout the world the decisions made by policy makers relating to how financiers may deploy capital can influence the incentives of credit originators and affect the overall indebtedness of consumer borrowers. These financial structures and the incentives they create are one additional color in an accurate picture of consumer overindebtedness. In particular, this section continues to look at how the structure of a country’s home mortgage industry may create incentives for the front line finance industry sales and origination staff to aggressively market loans with poor chances of successful repayment.

Private label subprime mortgage securitization in the United States has created an incentive structure that has led millions of consumers into overindebtedness. Because securitizing originators quickly assign their loans, their own capital is only invested in any given loan for a short period of time. In the height of the subprime refinancing boom of the last few years, many mortgage originators were moving their inventory of loans into the secondary market four or five times a year. Many of the most aggressive home mortgages included introductory ‘teaser’ interest rates that did not adjust upward until long after the loan was sold by originators into the secondary market. There was virtually no initial risk to originators of holding a defaulting loan. Once a loan was sold, the company was free to use the proceeds of the sale to find a new consumer for another loan, and so on. In effect, private label subprime securitization used the international capital markets to transform relatively small businesses into multi-million dollar institutions with a tremendous impact on the lives of entire communities.

For mortgage brokers and originators this market structure changed the mortgage lending business from a game of pushing for a marginal return on assets realized through the collection of principal and interest, to one focused above all else on volume. American subprime mortgage brokers are generally paid through commissions on the number and size of loans they sell. In practice the mortgage origination business in the United States has devolved from one focused on predicting the ability of borrowers to repay and the future value of

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60 J Laing, ‘Garbage in, Carnage Out: As Borrowers Default, Investors in Securitised Subprime-Loan Instruments such as CDOs could Face Losses Exceeding $100 Billion. Echoes of the S&L Mess’, Barron’s (New York, 9 July 2007);
collateral into an aggressive marketing more akin to automobile sales than underwriting. Indeed, it was to used car dealers that some American mortgage brokers turned in developing their sales personnel.61

The compensation structure of American mortgage brokers creates the incentive to mislead borrowers on how much they can afford to borrow. For example, one compensation method known in the US as ‘yield spread premiums’ was an important tool used by brokers to steer consumers into overpriced loans in the prelude to the subprime home mortgage meltdown.62 Sometimes referred to as servicing release premiums, overages, back-end compensation, or premium pricing—yield spread premiums were compensation paid directly by a lender to a mortgage broker from proceeds of the consumer’s loan, which the borrower will repay (with interest) over time.63 Yield spread premiums are paid, in addition to the usual brokers’ fee, when brokers deliver ‘above par’ loans.64 By above par, lenders mean that the borrower is agreeing to a more costly loan than the borrower qualifies for under the lender’s standard underwriting guidelines.65 Lenders constantly keep brokers up to date on the rates and terms lenders are willing to offer. Borrowers do not object because it never occurs to them that they are paying a fee of thousands of dollars for the privilege of paying a higher interest rate. As a result, yield spread premiums ‘vary not by the quantum of services provided, but by how aggressive the broker/lender may be and how little the consumer knows.’66

But, even where borrowers paid ‘par’ rates for their loans, brokers and originators still had the incentive to drive up volume, both in terms of the numbers of borrowers approved for loans and in terms of the size of loans each borrower obtained. With respect to the latter, even absent yield spread premiums, brokers

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62 In the US, a ‘yield spread premium’ generally refers to a payment made by a loan originator to a loan broker in exchange for obtaining a consumer’s agreement to pay a higher interest rate than the borrower qualifies for under the originator’s own underwriting guidelines. C Peterson, ‘Federalism and Predatory Lending: Unmasking the Deregulatory Agenda’ (2005) 78 Temple Law Review 1, 15–16; C Peterson, Taming the Sharks: Towards A Cure for the High Cost Credit Market (Akron, University of Akron Press 2004) 142.


64 Predatory Mortgage Lending Practices: Abusive Uses of Yield Spread Premiums: Hearing before the U.S. Senate Committee on Banking, Housing, and Urban Affairs, 107th Cong. Part I (January 2002) [hereinafter Yield Spread Premium Hearing] [prepared statement of Ira Rheingold] (‘I have seen countless loans that contained both yield spread premiums and borrower paid broker fees, yet not once have I spoken to a homeowner who knew that a YSP had been paid on their loan, or that because of the [yield spread premium], the interest rate they received was greater than they were otherwise qualified.’).


and originators in the subprime market frequently obtained compensation through ‘points’—with a point usually referring to 1 percent of the total amount financed. A generation ago, American borrowers typically paid ‘points’ to purchase a lower interest rate. But in recent years this charge has devolved into essentially an origination fee. In a loan with a one point origination charge, for every extra $10,000 in debt taken on by the debtor, the broker or originator receives an extra $100 in compensation. In the high-pressure sales environment created by most subprime mortgage brokerages, these commissions are the core component of employee compensation. If brokers do not close loans, they are not paid; and, other things being equal, the smaller the loan, the less pay the broker takes home.

Another credit pricing feature which facilitated the American subprime market meltdown was the widespread use of ‘teaser’ pricing. Millions of American subprime loans underwritten in recent years have included low initial payments or interest rates set to adjust upward a relatively short time after origination, generally two or three years.67 Brokers commonly encouraged debtors to buy debts with teaser pricing, explaining away any concerns with the rationale that ‘you can just refinance later.’ During the several years of double-digit housing appreciation in many American markets, this statement was true. Consumers who were making little or no payment on the principal of their loans would nevertheless accumulate equity as a function of housing inflation. But, after years of stagnant wage growth, the continued growth of housing prices in many markets became unrealistic. It was not as though in aggregate, consumers had more money to pay for shelter. Housing prices could not rise indefinitely. Indeed it was probably the new unrealistically underwritten and creatively reckless financing plans offered by so many mortgage lenders that was helping sustain the bubble in home pricing in the first place. As each consumer sought to refinance their home, their mortgage lenders and brokers put pressure on the home appraisal industry to appraise homes with values that gave the maximum ‘cash out’ latitude to borrowers and the largest commissions to brokers. Collectively these appraisals helped sustain an aggregate illusion of appreciation. Indeed, this pricing and appraisal structure built social and commercial norms tolerant of overindebtedness.

As these loans were sold to investment banks, then packaged into trusts, and then sold as securities, the investment banks structuring the deals had little incentive to police high-volume origination practices. Why? Because the investment banks themselves were also compensated by volume rather than repayment. Even advocates of securitization frequently characterize the fees of the attorneys, investment bankers, and accounts necessary to securitize a pool of assets as ‘astronomical.’68 The more dollar value in loans pulled in from an

68 Felson, above n 51, at 589.
investment banking firm’s origination pipeline, the sooner the firm can draw out
the fees for packing the deal.

The increasing use of collateralized debt obligations, or CDOs, has only
increased the incentive of Wall Street players to churn out puffed securitized
paper. Collateralized debt obligations are usually pools of various asset-backed
securities which are then structured and repackaged for investment. CDO
issuers justify their products by explaining that pools of asset-backed securities
can overcome credit risk problems of securitized pools of assets. For example,
any given securitized pool of assets may rely heavily on one type of loan, assets
originated by one lender, or even assets originated in one geographic area. By
purchasing some securities from many different pools, CDO issues create
greater diversification.69 But, best of all, the CDO issuer has another chance to
generate a round of fees based on the same aggregate amount of assets in circu-
lation. Unsurprisingly, some firms also offer ‘CDO-squared’ deals where CDO
tranches are purchased, repackaged again into yet another pool, and then once
more structured into a second level set of CDO securities.

The willingness of investors to purchase securitized mortgage tranches,
CDOs, and squared-CDOs has all come to hinge primarily on the judgment of
credit rating agencies. For their part, Moody’s, S&P and Fitch are also compens-
sated based on the volume of deals they rate. Their core financial incentive is to
help make most of the pools of assets they measure liquid. Obviously the judg-
ment of these companies will only be purchased over time if their estimates are
accurate. And no one doubts that these credit-rating professionals have labored
diligently to provide their customers with accurate measurements of credit risk.
But even the most sanguine amongst us can get carried away. With the benefit
of hindsight, the rating agencies do not appear to have accurately apprised
investors of the risks in the subprime mortgage lending market, particularly
with respect to mezzanine CDOs—CDOs that repackage middle-tier credit
risks from asset-backed securities. The hope was that diversification offered by
CDO structuring would rehabilitate some of the credit risk weaknesses in sub-
prime residential securitization pools. Of the $375 billion US CDOs issued,
about $100 billion is currently made up of subprime mortgages.70 As this chap-
ter goes to press, this market continues to be at risk, evoking reverberative
echoes of the US savings and loan crisis, the Japanese real estate bubble of the
late 1980s, and the real estate bust of the Great Depression.

For their part, neither the UK, Germany, nor Japan appear to have a similar
situation on the horizon. Nevertheless, as Part II of this Chapter attempted to
suggest, some of the market structures which facilitated the current American

69 J Gluck and H Remeza, ‘Moody’s Approach to Rating Multisector CDOs’ (15 September 2000)
70 R Tomlinson and D Evans, ‘The Ratings Charade: Subprime Mortgages Have Swept into the
Booming Collateralized Debt Obligations Market, Often in CDOs Awarded the Highest Grades by
Standard & Poor’s, Moody’s and Fitch’, Bloomberg.com (July 2007) <http://www.bloomberg.com/
crisis are either being deployed or are being actively considered by these countries. The UK’s increasing reliance on mortgage origination intermediaries as well as the wide acceptance of alternative and creative secondary market investment structures is similar to the American subprime mortgage lending pattern. While Japan has, in my view, wisely created a quasi-public entity to set the standard for prime mortgage securitization, subprime originators and private label securitization are making aggressive inroads into the Japanese marketplace. Moreover, Japan’s recent consumer finance legislation, which increases regulation of unsecured lending and lowers the national usury limit to 20 percent per annum,71 may push capital into aggressive subprime mortgage loans. Of the three non-US markets examined in this article, Germany appears to be furthest from the US subprime model. But even in Germany there are active voices at the EU level lobbying for a Union-wide marketplace based on the UK and US model.

IV. THE POLITICAL ECONOMY OF SECURITIZATION

As various national economies load more home mortgage and other consumer debt into securitization conduits, the ability of these countries to avoid the incentive problems seen in the American subprime home mortgage market will depend on the extent to which these countries have and enforce meaningful consumer protection law—both from the perspective of investors and debtors. To prevent overborrowing, consumers need meaningful disclosure of price and risk information at a useful point in their transactions. Consumers also need reasonable bankruptcy discharge provisions, to allow them reentry to commercial society in the event of personal financial failure, and also to deter overreaching by creditors. Consumers and investors need sound underwriting guidance from financial institution regulators. And deceptive, misleading and fraudulent business practice, such as the yield spread premiums tolerated by the American government, must be banned.

But in each of the modern democracies discussed in this article, the ability of governments to enact sound consumer protection policy is constrained by political reality. One of the most troubling features of securitization has less to do with its economic or financial nature than with its effect on the politics of consumer protection law. By enlisting capital markets in the once-shady fringe lending business, securitization dramatically empowers the opponents of consumer protection law. In the 1980s and early 1990s, American academics generally referred to high-cost consumer creditors as the ‘fringe lending industry.’ The appellation invoked a picture, then accurate, of a marginalized industry that

preyed on consumers by flying below the radar screen of law enforcement and the judiciary. But as we approach the year 2010, reference to ‘fringe’ lenders seems to have declined. The reason is not that fringe lenders went away, but rather that fringe lenders were purchased, capitalized, and politically embraced by America’s most powerful financial institutions. Surely this change reflects decades of growing cultural acceptance of neo-liberal economic theory. But no serious, concrete explanation of this change is possible without reference to securitization. Securitization made it possible for Wall Street to engage in the predatory lending trade without getting its hands dirty.

As the promise of wild profits drew investment banks, hedge funds, law firms, accountants, and credit rating agencies into lending practices once considered beyond the pale, older, seedier fringe lenders have found powerful new political allies. Previously I have called attention to a political fight that I believe was a crossroads in the evolution of the American subprime mortgage industry.72 By the end of the 1990s, the harmful side effects of securitizing subprime mortgages were becoming clear to legal aid attorneys, community activists, consumer advocacy organizations, and some attorneys general. In state legislatures around the country, consumer organizations began pushing for rules that would limit some of the harsh origination and servicing practices in subprime lending, as well as for assignee liability rules that would push the secondary market to more carefully police the overaggressive origination. After several years of effort, consumer advocates, with the aid of a sympathetic state governor, succeeded in convincing the Georgia legislature to pass legislation imposing unrestricted liability for illegal origination practices on assignees of high cost mortgage loans.73 The intent of the rule was to force mortgage investors to bear the full deterrent weight of consumer protection law along with brokers and originators.

In past generations, the Georgia legislation would have sparked political opposition from a coalition of thinly capitalized lenders that would have lacked moral authority having themselves engaged in the questionable behavior. But in the post-securitization world, the Georgia legislation ignited a public relations firestorm fueled by the New York City investment community establishment and financial institutions plugged into world capital markets.74 Leading the charge was none other than Standard and Poor’s, the credit rating agency, when it announced with some measure of dramatic flourish that it would no longer

73 2002 Georgia Laws Act 488, § 7-6A-6 (‘Notwithstanding any other provision of law, any person who purchases or is assigned a high-cost home loan shall be subject to all affirmative claims and any defenses with respect to the loan that the borrower could assert against the original creditor . . .’).
rate mortgage loan securities that included loans originated in Georgia. S&P and the other credit-rating agencies explained that the unrestricted liability imposed under the statute could mean that large punitive damage awards from angry juries could be foisted on to investors who had purchased securities from the pools including Georgia loans. The agencies argued that unlike more limited forms of assignee liability, such as that imposed by the US Federal Trade Commission’s holder notice rule, the risk posed by the Georgia Fair Lending Act was unquantifiable. Analysts believed that there was no way to know how much exposure investors would have from jury verdicts ahead of time. Bowing under the combined pressure from banks, thrifts, credit unions, corporate mortgage lenders, and powerful Wall Street firms, the Georgia Legislature buckled. It soon repealed its own law, replacing it with a more moderate statute—but only after seeking approval from Standard and Poor’s.

Placing this political response in context, the Georgia assignee liability rule was, at the time, the most aggressive American effort to deter some of the practices which have since led to the subprime mortgage market meltdown. But, viewed from an international perspective, Georgia’s response was by no means extraordinary. Even if the credit-rating agencies and investment bankers were correct that subprime lending would henceforth have been impossible within the state, viewed from an international perspective, this by itself is not such an unreasonable policy outcome. Germany today still has only a very limited subprime home mortgage market. And both the Japanese and the UK subprime mortgage industries are far more recent and less developed than their US counterparts. Irrespective of whether Georgia’s democratically elected leaders made the right decision in passing their initial subprime mortgage market legislation, the political reality behind what happened there cannot be overemphasized. When a coalition of mainly volunteer citizen advocates convinced their representatives to excise what had been viewed as a fringe industry from their commonwealth, the full political weight of the New York and world capital markets was brought to bear on the statehouse. The politics of consumer lending legislation became dramatically different when Wall Street began to invest in subprime mortgages.

For those people in the United Kingdom, Germany, Japan, and other countries that hope to preserve, or possibly even enhance, their consumer protection law, another strong caveat becomes clear from the US example. As capital markets invest in the employees, software, expertise, and business relationships

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necessary to securitize mortgages, those investors will gain a new financial stake in national and local debates over consumer policy. While many believe that US democratic institutions have suffered under the weight of lax campaign finance laws, even the most responsive democracies will find political pressure exerted by the world’s largest financial institutions difficult to resist. Once those institutions invest in subprime mortgages, consumer-friendly reform of the law governing those mortgages will be much more difficult.

Looking toward the future, the United States’ experience suggests a mixed review of securitization. On the one hand, in the quasi-public residential mortgage backed securitization market, Fannie Mae and Freddie Mac have acted as gatekeepers promoting relatively conservative underwriting of homes that borrowers can afford. Despite years of dire predictions of the instability of the GSEs, they have thus far managed to successfully weather the largest downturn in home prices since the Great Depression.78 Securities issued by the GSEs have proven a cautious and stable investment in American home ownership. On the other hand, while the private subprime residential mortgage backed securities market has provided a plethora of lending products, it has also proven unstable, susceptible to corruption, and only marginally effective in promoting home ownership. It remains to be seen whether the knowledge gained from the current crisis can be used by the subprime mortgage industry to prevent the same instability and questionable lending in the future. While investors will surely be more savvy in buying subprime secondary market paper, there is little reason to suspect that this, by itself, will translate into meaningful protection for consumer debtors. The real test will not come until housing values again start to rise, tempting originators and servicers with lucrative opportunities to strip American families of their home equity.

As the European Union contemplates further integration of its housing finance markets, the American example should give cause for concern. It is likely that in Europe national barriers to lending and wider asset pooling constrain the ability of markets to assign and pool risk, raising the cost of borrowing for moderate income Europeans at the margins. But the solution may not be as simple as tearing down national barriers. The United States’ experience suggests that unrestrained private label residential mortgage securitization can lead to both overindebtedness and predation. Many of the recommendations of the Commission’s Expert Group on Mortgage Funding should be revisited in light of the US subprime mortgage foreclosure crisis. Are independent origination intermediaries—brokers—a better way to originate loans than those currently used by various EU member states? Is the development of special servicers with greater economies of scale actually better for borrowers? And most importantly, if the EU is intent on facilitating home finance through securitization, perhaps it

would do well to reconsider whether one or more quasi-public entities ought to
be created as both the US and Japan have done. The success of Fannie Mae and
Freddie Mac in weathering the downturn in the US housing markets is a com-
pelling argument that the European Commission’s Expert Group on Mortgage
Funding may have too quickly dismissed the notion of a pan-European mort-
gage GSE.

As for Japan, its task may be to strike a careful balance between further pro-
motion of securitization and continuing consumer protection rules. Many of the
businesses and individuals that have profited in the US subprime market have
been looking and are likely to continue to look for other places to do business.
Japan’s large and aging population may prove too tempting a target for predatory
mortgage financiers to pass up. Financial institutions originating non-conforming
mortgage loans should be the subject of careful scrutiny and oversight.

V. CONCLUSION

This Chapter summarized the operation of the subprime mortgage lending
industry in the United States and compared that industry to the secondary mort-
gage markets in the United Kingdom, Germany, and Japan. All four countries
discussed in this Chapter have in recent years turned increasingly to securitiza-
tion to fund residential mortgage lending. While there are several widely known
advantages of securitization—creating lower capital costs and liquidity for
lenders being chief among them—questions remain regarding the effect of
securitization on consumer protection law. The US experience suggests that
securitization of subprime mortgages inadvertently created an incentive for
mortgage brokers and originators to market unrealistic levels of debt to
American borrowers. Without some systemic check, such as the influence of a
public secondary market infrastructure or close banking oversight, securitiza-
tion can contribute to overindebtedness. The US experience should serve as a
warning to the UK, Germany, Japan, and other countries about the danger of
using securitization conduits to originate low quality loans, and then passing
those loans on to unsuspecting investors.

With respect to the American experience, one syndicated newspaper colum-
nist recently summarized the US subprime lending crisis thus: ‘The bottom may
fall out of the economy, but the mortgage companies and the investment
bankers who ultimately provide the money have already walked off with big
bags of loot.’79 In July of 2007 when the fallout from subprime mortgage lend-
ing was becoming clear, Federal Reserve Chairman Ben Bernanke testified to
Congress that subprime losses were merely a ‘bump in the road.’80 While time

79 F Harrop, ‘Curtailing Creepy Creditors’, Sun Times (Biloxi, MS, 6 April 2007) <2007 WLNR
6596129> accessed 8 January 2008.
80 JB Bruno, ‘Loan Worries Alarm Investors, But Economists Doubt that Subprime Mortgage
has proven Chairman Bernanke incorrect, what was perhaps more troubling was the insensitivity of the remark coming from of the leader of the one of America’s most powerful consumer protection regulators. Surely the impending foreclosure on more than two million homes was no small impediment for those displaced families. Chairman Bernanke’s remarks are particularly galling given that in the Home Ownership and Equity Protection Act of 1994 Congress tasked the Federal Reserve Board of Governors with implementing the one federal consumer protection statute aimed at preventing ill-advised and abusive home mortgage lending. Under this act, Congress recognized that it was not well suited to respond to the rapid change and complexity of consumer protection challenges in residential mortgage lending. So Congress explicitly delegated wide authority to the Federal Reserve to revise and amend HOEPA regulations to protect Americans from unnecessarily losing their homes. In the long preamble to the subprime mortgage crisis, consumer protection organizations called on the Federal Reserve to update HOEPA regulations again and again, but to no avail. Time now appears to have proven those requests well founded.
I. INTRODUCTION

This chapter addresses the question of how consumer overindebtedness is currently regulated in Brazil by the 1990 Consumer Protection Code and what effects the new massification of credit to the lower-class consumer may have on the need for a new consumer bankruptcy legislation.

Our first thesis is that Brazil has experienced a ‘consumer credit explosion’ in the last five years, which requires new legislation for individual bankruptcy. We began this research in the Federal University of Porto Alegre in March 2004, with the creation of a research group in consumer overindebtedness. At this time, as José Reinaldo Lima Lopes wrote,1 there was little data about the state of overindebtedness of the Brazilian population, so we decided to conduct our own

* This Chapter is based on a paper prepared for the 2007 World Congress of the Law and Society Association, 24–28 July, Berlin. We would like to thank Iain Ramsay and Bill Whitford for the kind invitation to join this panel, also all the team of students, professors, judges, pro-bono public attorneys (Defensores Públicos) and public servants from PROCON-São Paulo who helped us with the research, in the persons of Rosângela Cavallazzi, Heloisa Carpena, Marcela Olíboni and colleagues of the Defensoria Pública-RJ, of Roberto Pfeiffer and Marli Sampaio (Directors of PROCON-SP), Adriana Burger and colleagues of the Defensoria Pública-RS, and the UFRGS-Research Team (Grupo de Pesquisa CNPq ‘Mercosul e Direito do Consumidor’), Karen Bertoncello and Clarissa Costa de Lima (LLM, UFRGS), Wellerson Pereira (UFRGS-Savoie) and Silvio Batello (Dr, UFRGS), Marcus Vinícius Madeira and Vicente Rota (LLM, UFRGS), students Carla Alimena and Alexandra Pretto (PIBIC-CNPq-UFRGS). The survey of the Court decisions was made by Antonio Herman Benjamin in Portuguese; the English text was written by Claudia Lima Marques, who claims responsibility for all errors. We thank Fabio Morosini (PhD, UT-Austin and invited professor at UFRGS) and Lucas Lixinski (PhD candidate, European University Institute; LLM, Central European University, Budapest, Hungary; UFRGS) for the correction of the English version and Iain Ramsay, Johanna Niemi-Kiesiläinen and Bill Whitford for the kind editing of the final text.

empirical research to evaluate the profile of the consumer in financial distress and the need for new legislation on individual or consumer bankruptcy in Brazil.

We also undertook a survey of the decisions of the Brazilian High Court of Justice (Superior Tribunal de Justiça) in the area of credit, which demonstrates how Brazilian judges are dealing with the absence of specific rules about consumer bankruptcy and how new legislation is needed.

The core of our analysis of the need for specific consumer bankruptcy regulation in Brazil will be developed by reference to three empirical researches made by our study group. We analyze the lessons of these empirical researches about the profile and characteristics of Brazilian consumer overindebtedness. Also, we compare the results of three empirical researches made in different regions of Brazil (Rio Grande do Sul, Rio de Janeiro and São Paulo) to verify whether current legislation is sufficient to prevent consumer overindebtedness, especially the overindebtedness of the lower class consumer. The analysis of 100 cases in Rio Grande do Sul, 32 cases in Rio de Janeiro and 38 cases in São Paulo will be our main material and subject. We also argue that the cultural and economic diversity in Brazil requires an adaptation of the French model for the treatment of consumer bankruptcy.

II. CONSUMER CREDIT EXPLOSION IN EMERGENT BRAZIL?

Especially in the last five years there has been a substantial growth of disputes involving consumer credit contracts in Brazil.2 Since 2001, the Superior Tribunal de Justiça, the highest civil court in Brazil, has decided many cases about consumer credit.3 As credit card companies are not subject to the Usury Act of 19334 (and its laesio enormis) in Brazil, the Superior Tribunal de Justiça clearly stated that the 1990 Consumer Code5 must apply to assure reasonable interest rates and good faith in these financial contracts. In cases of unemployment, the highest court permitted the termination of the financial contract.6

In 2001, our Constitutional Court, the Supremo Tribunal Federal, was asked by the Bank Confederation (CONSIF-Confederação Nacional do Sistema Financeiro) to decide on the constitutionality of this application of the Consumer Code to consumer credit. In 2006, the court concluded in favour of

2 See CL Marques and RL Cavallazzi, Direitos do Consumidor endividado: Superendividamento e Crédito (São Paulo, Editora RT, 2006) I-VI.
3 Source <www.stj.gov.br> accessed 13 July 2007. There are 67 consumer cases claiming laesio enormis and rebus sic standibus and 520 cases about interest rates and void contractual terms in financial services.
4 See the consolidation of the leading cases, called Súmula. STJ’s Súmula 283 states: ‘Credit Card companies are part of the Bank system so they are not subject to any interest tax limitation of the Usury Act.’
5 See STJ’s Súmula 297: ‘The Consumer Code applies to financial services providers’.
6 The leading case is: STJ, Recurso Especial 200.019/SP, 17.05.2001, DJ 27.08.2001, Ari Pargendler.
its full constitutionality, with 9 votes to 2, affirming that the Consumer Code must apply to all financial contracts with consumers, including consumer credit, consumer deposits, bank services and credit cards. In addition, in the state (administrative) mediation system for consumers’ complaints, called PROCON, one of the most disputed topics in Brazil recently was financial services to individual consumers, especially in the southern states of Brazil, representing more than 25 per cent of consumer complaints. From March 2006 to December 2007, in the state of Rio de Janeiro, 29.59 per cent of the disputes were complaints against banks, credit card companies and financial services enterprises, and in Rio Grande do Sul, 29.69 per cent. Financial services were also the most important topic for the consumer movement in the last five years, and for scholarly writing.

At the same time, the democratization of access to consumer credit has exposed the frailty of this legislative framework. Brazilian law does not know a consumer individual bankruptcy system, only a general Consumer Protection Code from 1990, with only one provision about information and disclosure in consumer credit (Art 52 of the Brazilian Consumer Code (BCC)). Bankruptcy law in Brazil—like almost all systems of the Roman-German law family in the 19th century—allows only businessmen (‘comerciantes’), either as individuals or incorporated legal entities, to file for bankruptcy and relief (‘Falência e Recuperação Extrajudicial’). Consumers are excluded from these privileges. For individual consumers there are some limits to debt collection, and restrictions imposed on the enforcement of creditor remedies in Brazil can include also

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9 In the Administrative Consumer Protection Departments, called PROCON, from the state Rio de Janeiro 29.59% of the disputes and mediation were around financial services (19,718 disputes from the total of circa 66,637 disputes and negotiations) and 29.69% from the State of Rio Grande do Sul (8,107 disputes from the total of circa 27,304 disputes and negotiations in this period of time). Source: SINDEC, Brazilian Ministry of Justice, <www.mj.gov.br/Sindec> accessed 15 January 2008.

10 See analysis of the 20 years of IDEC, Instituto Brasileiro de Defesa do Consumidor, São Paulo, in <www.idec.org.br>.

11 See leading cases about Art 52 of the Consumer Code in CL Marques, AHV Benjamin and B Miragem, Comentários ao Código de Defesa do consumidor 2nd edn (São Paulo, Editora RT, 2006) 775.

12 R Requião, Curso de Direito Falimentar vol I, 15nd (São Paulo, Saraiva, 1993) 14.

13 Lopes, in Niemi-Kiesiläinen, Ramsay and Whitford 91 ff.

the single family house (‘Bem de família’), when reasonably small and in use by all the family. Here we must note that the public support programs are very restricted in Brazil, normally reaching only the poorest 22 per cent of the population, and unemployment insurance lasts only three months. In any event, creditors’ chances of debt recovery tend to be very low in Brazil.

In case of a plurality of creditors, Brazilian law knows an old institution for the benefit of creditors, that allows in case of individual insolvency a special order for the payment of the creditors, the so called ‘concurso de credores’ (Arts 711–713 Brazilian Civil Procedural Code). This is very rarely used in practice. The ‘concurso de credores’ cannot be compared to an actual individual and consumer bankruptcy, because the rationale here is exactly the opposite, it is to facilitate the payment to more than one creditor and can be used only by the creditors. The consumer must open a claim against each one of the creditors to renegotiate his/her debts. Brazilian procedural law provides no collective remedy for an insolvent consumer.

The idea of a global renegotiation of all debts with all creditors to help good faith consumers pay their debts is a new concept in Brazil. But in our opinion, all modern legal systems must address the question of how to respond to the needs of insolvent individual consumers whose burden of debt greatly exceeds (50 per cent) their capacity to repay within a reasonable time frame.

The democratization of credit is a reality in Brazil. In recent years consumer credit and credit cards have increased extraordinarily in Brazil, especially credit to poor families, to working households and to the lower middle class, which represents 77 per cent of the Brazilian population. In 2007 alone, the financial services and credit market has been experiencing an increase of 9.2 per cent, incomparable with the growth of other sectors of the economy, such as the

16 Lopes, in Niemi-Kiesiläinen, Ramsay and Whitford 92.
20 The actual population of Brazil is estimated at 186 million, but the last data are from the 2000 census, showing a population of 169,799,170, with 81.25% urban and 18.75% rural population. Source: <www.ibge.gov.br> accessed 15 January 2008 and <www.sidra.ibge.gov.br> accessed 15 January 2008. See also Revista Veja (26 April 2006) 101 (São Paulo).
increase of 2.1 per cent of the agricultural sector, 4.6 per cent of the services sector or the 3.0 per cent of the industrial sector in the same period.\textsuperscript{21}

One explanation for this growth is the development of the country itself and the State programs to combat poverty. In 1996 poverty reached 29 per cent of the Brazilian population; this proportion decreased to 22 per cent (and 20.37 per cent in urban areas) in 2005.\textsuperscript{22} In 14 years (1992–2005, the last two administrations of Presidents Cardoso and Lula) poverty in Brazil decreased about 22 per cent with an annual average 5.2 per cent decrease.\textsuperscript{23} On the other hand, in the last 10 years, the minimum wage increased its value almost 90 per cent in Brazil (compared to consumption costs).\textsuperscript{24} From 2003 to 2005, with social programs targeting poverty, the income of the 50 per cent of the poorest population in Brazil increased 8.4 per cent.\textsuperscript{25} The Brazilian Institute for Statistics (IBGE) estimates that 77 per cent of the Brazilian population can be classified as individuals from the classes C, D and E who earn 1 to 10 times the minimum monthly wage, the equivalent of between US$ 175.00 and US$ 1,750.00 per month.\textsuperscript{26} From 2002 to 2007, the index of family consumption increased in general from 0.91 in 2002 to 5.26.\textsuperscript{27}

A further possible explanation is the growing interest of the bank and credit card industry in micro-financial markets or the subprime market of Brazil.\textsuperscript{28} The Brazilian Bank Federation, FEBRABAN (Federação Brasileira de Bancos), indicates that in 1996 the amount of credit to individuals or consumers represented only 12.1 per cent of the total of loans and credit provided in the Brazilian banking system; in 2005 consumer credit reached 45.8 per cent.\textsuperscript{29} Data for 2007 is not yet available, but it is expected to show a record increase of credit offered in Brazil.\textsuperscript{30} This means that almost the same value provided to finance commerce and industry will be contracted with consumers.\textsuperscript{31}

\textsuperscript{24} Source: Lucila Soares, ‘Crediário’, in Revista Veja (26 April 2006) 103 (São Paulo).
\textsuperscript{26} Source: <www.sidra.ibge.gov.br> (15 January 2008, data from 2003). See also Revista Veja (26 April 2006) 103 (São Paulo).
\textsuperscript{27} Source: FEBRABAN, PIB-Consumo das famílias, in <www.febraban.org.br> (14 July 2007).
\textsuperscript{30} Source: FEBRABAN, <http://www.febraban.org.br> (13 January 2008). The November 2006–2007 data are: 34.1% for consumer credit and 4.9% for individual houses (in total: 39%), 22.6% for the industry, 10.4% for commerce and 9.7% for the agricultural sector, in ‘Relatório Febraban—Evolução do Crédito do Sistema Financeiro Edição de 27 de dezembro de 2007’, in <www.febraban.org.br> (13 January 2008).
\textsuperscript{31} Source: FEBRABAN, <http://www.febraban.org.br> (13 January 2008). The consumer credit reached in November 2007 34.1% and to industry (22.6%) and commerce (10.4%) reached only 33%. See also L Soares, 101.
After 2004, the government permitted wage assignments, and retired persons in particular want to use this new form of ‘withholding credit’ (crédito consignado) where the interest rate is controlled (currently 2.64 per cent a month). From 2004 to January 2008, 55 banks have been allowed to work with this kind of credit for the elderly and they have concluded over 22 million of these credit contracts with 8.7 million retired people. Fifty-nine per cent of these retired persons earn as a pension only the minimum wage (circa US$ 175.00). Fifty-six per cent of these loans are for payments for 31 to 36 months. Indeed, the Banks Federation in Brazil, FEBRABAN, indicates that individual loans increased eight times, from 5.68 in 2002 to 46.11 in 2005, in particular because of the introduction of wage assignments and also credit for retired persons (‘withholding credit’). The withholding credit (‘crédito consignado’) increased 27 per cent in 2007 and represents today 57 per cent of the volume of individual and consumer credit offered in Brazil.

Credit card companies have also struggled for a share of this new market. From 2001 to 2005 the credit card companies have aimed for this new market and have increased their clients’ portfolios by 118 per cent. In the classes C, D and E of the Brazilian population (this new subprime market) the credit card companies average a 144 per cent increase. The Association of Credit Card Companies in Brazil (ABECS) indicates that in 2000 there were 119 million credit cards in the Brazilian market and that in 2007 this number had more than tripled, reaching 413 million credit cards in Brazil. The trend now is that every big store, football club or big company has a special credit or client card. These special credit cards increased from 42 million cards in 2000 to 120 million cards in 2006 and 132 million cards in 2007, all allowing the consumer to finance in 30 days to 10 months the debt (cartão de loja).

34 Source: Ministério da Previdência Social, <www.previdencia.gov.br> (14 July 2007). 83% of the withholding credit consumers have one to three minimum wages as pension, that means circa US$ 175.00 to US$ 525.00.
38 Source: L Soares, 101.
So we argue that we can now speak of a ‘credit explosion’ in Brazil, followed by a ‘credit hangover’ period that we are supposed to be entering now. The Brazilian Bank Federation, FEBRABAN, reports an eight-fold increase in individual credit but an increase in insolvency, from only 4.57 in 2002 to 7.1 per cent in November 2007. Also the Previdência Social (Social Security) Department of Retirement (INSS), indicates that 8.7 million elderly people have concluded over 22 million contracts, indicating that each individual has on average two credit contracts to pay (or to renew when it becomes impossible for them to pay). We call this phenomenon a ‘credit hangover’ period, a time when these ‘new’ and poorer consumers cannot afford to pay their own debts, but they are still in the bank and credit card system as solvent clients (with a delinquency of less than three months).

In other words, these consumers need credit to make ends meet by the end of the month and they renew their loan contracts and take credit by their credit cards. IBGE indicates that in 2003 around 50.88 per cent of Brazilian households needed some kind of help or credit to finish the month within their budget. Data show this link between the credit explosion and the current debt hangover in Brazil. Thus, in the credit card system the number of consumers that need credit at the end of each month is increasing, as are the amounts that they are financing. From 2000 to 2006, the amount of consumer credit requested from the credit card companies (that is, consumers that pay only the minimum payment on their credit card) has tripled in Brazil: from R$ 48.4 million in value (around US$ 24.2 million) in 2000 to R$ 151.2 million (circa US$ 75.6 million) in 2006.

III. THE LESSONS THAT CAN BE DRAWN FROM THREE EMPIRICAL STUDIES (RS, RJ, SP) IN BRAZIL

As we have already mentioned, Claudia Lima Marques began the research in the Federal University of Porto Alegre (UFRGS) in March 2004, with the creation of

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41 See an article from Carina Nucci in Revista Veja (18 May 2005) 90 ff, the credit hangover: ‘Ressaca do crédito’.
a research group on consumer overindebtedness, inspired by the work of Iain Ramsay in Canada and Leitão Marques in Portugal. From March to July 2004 this group started research in 10 cities in Rio Grande do Sul (RS). With the help of the Defensoria Pública-RS (a pro-bono state lawyer clinic) we interviewed (questionnaire with open and half-open questions) 100 consumers in economic distress. The objective was to understand the profile of the overindebtedness in Southern Brazil. The research was presented in October at a national congress at UFRGS with the Ministry of Justice and the need for new legislation on individual bankruptcy was established (Carta de Porto Alegre 2004). Colleagues from the Defensoria Pública of Rio de Janeiro wanted to conduct similar research in their state and began a pilot project about global renegotiation and payment plans for consumers in economic distress in the city of Rio de Janeiro. Rosângela Cavallazzi (UFRJ) and Heloísa Carpena (MP-Rio) organized the research. The preliminary screening was made with 80 people; 32 were chosen for the second phase of the research (the interview).

The results of the two research projects were presented internationally at the Tenth Congress of the IACL—the International Association of Consumer Law—in Peru in 2005. In Brazil, the conclusions were presented at the Fifteenth Anniversary Congress of the Consumer Code, organized by the Brazilconsumer (Instituto Brasileiro de Política e Direito do Consumidor), in Gramado and the Ministry of Justice agreed to commission our group to present some preliminary ideas and a study about the need for a Consumer Bankruptcy Law, to assist the later formation of an expert drafting commission.

As the pioneer in empirical studies in this subject in Brazil, José Reinaldo Lima Lopes wrote that there are few data about the state of consumer overindebtedness available. So, in 2006, we also decided to organize a research project in the city of São Paulo, the largest consumer market in Brazil, with 12 million people. The PROCON-SP and its Director at the time, Marli Sampaio, formed the Department of Overindebtedness and Negotiation of Payment Plans. The response to its formation was overwhelming. In three days, 1,200 consumers requested on the Internet to be included in the first phase of the interview, and they decided to limit the interviews to consumers with more than three creditors in order to study the process of global mediation. They conducted 120 negotiations. Claudia Lima Marques and Rosângela Cavallazzi

47 UFRGS Research group in 2004: Claudia Lima Marques (Main researcher, Professor at Law), Clarissa Costa de Lima and Káren Rick Danilevitz Bartoncello (Judges), Silvio Javier Battello Calderón (PhD candidate), Carla Alimena, Alexandra Pretto, Eduardo Wambier, Cyro Annes, Lucas Lixinski, Diego Lerner and Simone Backes (law students), Marcus Vinicius Madeira and Vicente Rota (LLM, UFRGS).
51 Lopes, in Niemi-Kiesiläinen, Ramsay and Whitford, p 91 ff.
conducted further, more modest research with the new Director of PROCON-SP, Roberto Pfeiffer, and 38 new cases were interviewed and will be presented here.

When we look at these three empirical researches (RS-2004, RJ-2005, SP-2007) we realize that these empirical data are quantitatively very limited, but their quality could be assured through the use of the same methodology, the two personally conducted interviews and the annex documents. The bank and credit card industry, and the Credit Bureau (SERASA, SPC etc) in Brazil have available a lot of other data, mostly based on its own second-hand information and register. We preferred not to use these data because they do not distinguish between debts of individual consumers, enterprises and professional debts of professionals, because in theory under the Consumer Code legal entities can also be considered consumers (Art 2 of the Consumer Code). For legal entities, including both non-commercial and commercial, there is the possibility to ask for a bankruptcy in existing commercial law in Brazil, so these economic agents do not interest us. Our study focuses only on the state of overindebtedness of the individual consumer and the question whether there is a need for a bankruptcy law for the relief of individual debts.

We rest our conclusions on our own limited data. The three empirical studies in Southern Brazil are very rich in detail and provide us with much relevant information about the profile of the consumer in financial distress and about the need for new legislation on individual or consumer bankruptcy in Brazil.

A. The 2004 Rio Grande do Sul Empirical Research: How to Detach Consumer Overindebtedness from Poverty in Brazil?

This research was conducted in 10 different towns in Southern Brazil (RS) in the pro-bono state lawyers clinic, where poor consumers can get legal aid for free, called the Defensoria Pública do Rio Grande do Sul, and coordinated by Director Adriana Burger (DP-RS) and Claudia Lima Marques (UFRGS). One hundred and twenty interviews were conducted, but consumers with debts to the state (taxes etc) arising from family law or criminal law, or with public loans in the so-called Housing Finance System (SFH—Sistema Financeiro da Habitação) were excluded. One hundred consumers also took part in the

52 The cities are: Porto Alegre (Capital of State of Rio Grande do Sul, 1.7 million people) and Gravataí, Charqueadas, Barra do Ribeiro, Montenegro, Sapucaia do Sul, São Leopoldo, São Sebastião do Cai and Taquara.

53 The research group coordinated by Adriana Burger were: Porto Alegre—Christine Balbinot, Daniela Boito Maurmann Hidalgo, Jussara Barbosa Acosta, Sandra Regina Falceta and Vera Adegas; Gravataí—Bruno Miguel Gil and Clevenice Scopel; Charqueadas—Lisiane de Cássia Zanette Alves; Barra do Ribeiro—Andréa Gubert; Guaíba—Rafaela Consalter; Montenegro—Cristiano Vieira Heerd; Sapucaia do Sul—Cristiane Angelita Johann; São Leopoldo—Josane de Almeida Heerd; São Sebastião do Cai—Paulo André Carrard; Taquara—Eugylene Chiarello.

second phase of the interview, bringing documents to prove their economic situation. Only individuals who in their household have three minimum wages as a monthly budget can get this pro-bono state legal aid. The purpose here was to understand the profile of overindebtedness in Southern Brazil.

i. Main Results in RS

The first part of the interview aimed at delineating the profile of the individual consumer in distress or in overindebtedness.\footnote{See my definition of consumer overindebtedness, in CL Marques, Contratos no Código de Defesa do Consumido (São Paulo, Editora RT, 2005) 1053.} From these 100 cases, the main results are the following: 55 per cent were women, 58 per cent were not married (single, 30 per cent, divorced, 20 per cent, widowed, 8 per cent), 66 per cent aged between 30 and 50 years old, 47 per cent self-employed or from liberal professions, 11 per cent retired and 10 per cent unemployed. Forty-five per cent of the households had three or four people (the consumer and two children, for example).

The second part of the interview was about the patterns of debt and the role of marketing. Thirty-six per cent of the consumers had debts with only one creditor, 38 per cent with two or three creditors, only 7 per cent had 4, 5 or more creditors, which would permit a global renegotiation of their debts without much cost. The type of creditor was: department stores and big stores (28.4 per cent), banks and financial industry (23.8 per cent), credit cards (25 per cent), supermarkets (8.5 per cent), and the balance were debts to friends, energy and water costs, telephone bills, etc (circa 14 per cent). The most common causes of indebtedness were: unemployment (36.2 per cent), injury, sickness or accidents (19.5 per cent), divorce (7.9 per cent) and death of the consumer or someone in the family, and 21.7 per cent abuse of credit.\footnote{See with the same common causes, ‘Unemployment or Underemployment, Credit Cards, Sickness and Injury, Divorce, Housing’, TA Sullivan, E Warren and JL Westbrook, The Fragile Middle Class—Americans in Debt (New Haven, Yale University Press, 2000) 75.} We concluded that using the French classification of passive overindebtedness, good-faith consumers that have experienced a life ‘accident’ and needed only more time to pay their debts with their actual budget, represent 79.3 per cent of the group. A maximum 21.7 per cent have abused the credit and cannot cope well with credit and the open consumer society. The role of marketing was also probed. Consumers did know about the source of the credit they used: television (22.4 per cent), flyers and marketing personnel on the street (20.6 per cent), direct mailing and e-mails (11.2 per cent), door-to-door marketing (2.5 per cent), and 31 per cent of the consumers said that at the supermarket, bank or big store they received information about the credit (31 per cent) or they received the information from friends or family (8 per cent) and 3.4 per cent could not remember.

The third part of the interview was about two legal issues: if the state or public attorneys’ office help to renegotiate the debt was sufficient, and if the credit

\footnote{Also 9.4% were other causes, like helping relatives, children and friends, growth of the family, repairs in the house, etc.}
was given in a legal and responsible way (crédito responsável), with the creditor providing all information required by Art 52 of the Brazilian Consumer Code.

The consumer in economic distress in Brazil can bring a claim, free of any charge, before the administrative mediation system PROCON, in each city and state, or in the small claims tribunals, with or without a lawyer. The consumer can also propose an action without fees, with help of the pro-bono legal aid, Defensoria Pública, before ordinary courts. Of the 100 consumers that were in the Defensoria Pública, 69 per cent had already asked for help before; 67 per cent tried to make an agreement with the creditor by themselves; 17 per cent tried in the PROCONs; 10 per cent in the small claims tribunals, without success. That 67 per cent of the consumers tried to reach an agreement or a renegotiation with the creditor without success is a very significant indication of how law protects creditors’ rights in Brazil, so that it is more profitable to have an insolvent consumer in the payment list instead of accepting a voluntary repayment plan.

Article 52 of the Consumer Code requires information on the total debt, with and without interest, disclosure of the annual interest rate, review of the payment data, and a copy of the contract. The results in Rio Grande do Sul were that in 61 per cent of the cases the creditor did not calculate the total amount of the debt (37 per cent did calculate and 2 per cent could not answer this question). The copy of the contract was given before signature of the contract in only 17 per cent of cases (82 per cent not); in only 43 per cent of the cases was a copy of the contract provided, and in 26 per cent of these cases after the contract was signed. We conclude that Art 52 of the Consumer Code has almost no positive impact in the imposition of fairness and disclosure in consumer credit in South Brazil.

On the other hand, creditors review the income of the debtor before the signature of the contract in 70 per cent of the cases, but do not ask for assurances (secured credits). For these lower-income consumers only 23 per cent of the creditors required such assurances (64.2 per cent personal guarantees, 28.5 per cent check on overdraft accounts, and only 7.4 per cent asked for a mortgage).

**ii. The Lesson: Poverty Mixed with Overindebtedness in South Brazil**

In 2004 the average level of development was 3.5 per cent, and Brazil was the eighth economy in the world. But Brazil has a very uneven structural division of wealth in society, as more than 22 million people (31.9 per cent of the population) receive as income only one minimum wage, in 2004, US$ 100–130 per month. In 1990, IBGE estimated that poverty reached 30 per cent of the population in Brazil and in Rio Grande do Sul, 17.6 per cent of the urban population.

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In 2004, the FGV estimated poverty in Brazil as representing 25.38 per cent of the population. At the time this research was conducted, in 2004, the credit explosion to the lower-income classes, C, D, and E, was only beginning. Today the credit card industry estimates that this market may represent 35 million new credit card customers. Brazil has 185 million inhabitants, with 89.3 million active workers, and an average unemployment rate of 8.4 per cent of the active population. Scholars also estimate the underemployment average as 41.3 per cent of the active population, which means a great phenomenon of hidden unemployment (chômage caché) in Brazil. Poverty is the great social problem and this research in 10 cities of Rio Grande do Sul was the only one of the three research studies based on limitation of income: it sampled only lower-income consumers.

In our opinion, the most important lesson of this empirical research was the difficulty to distinguish among these lower-income households, and determine whether the problem was poverty or overindebtedness. The two phenomena present themselves together, and the lack of a public safety net in Brazil for these consumers may mean that they try to solve their economic problems through credit.

IBGE estimates that 77 per cent of the Brazilian population can be classified as belonging to these lower-income classes, C, D, or E, so any individual bankruptcy law must acknowledge this difficulty. Some data about households in Brazil can help understand the importance of that poverty rate. According to an analysis done by IBGE about consumer household expenses and budgets in 2003 only 14.54 per cent of households in Brazil ended the month without budget problems. In contrast 34.57 per cent of the households have difficulties, but do not need credit to finish the month within their budgets. However, half of the population in 2003 had great problems to finish the month within their budgets and needed state help or credit to make ends meet. 82.41 per cent of the house-

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65 J Doll, ‘The Situation of Elderly Workers in Brazil’, in TALES, Third Age Learning Studies, Proceedings of the XII International Seminar 12 (Saskatoon, Canada, TALES, 2002) 8: ‘In 1991, casual work represented 41.3% of the total labor force, but rose to 51.3% in 2000. This high number of informal work is a problem, especially for Social Insurance benefits, because these workers do not pay contributions . . . IBGE/PNAD 1999.’ The 2006 IBGE/PNAD research shows new numbers of the informality in Brazil, 56.4% in 2005 and 56.4% in 2006. Source: <www.ibge.gov.br/pnad>.
66 See <www.ipea.gov.br> or <www.cut.br>, O Trabalho Informal no Brasil (1 May 2005) 3.
hold budget was used for consumption, as follows: 29.26 per cent for housing, lease of homes or habitation, 17.10 per cent for food, 15.19 per cent for transport, 5.35 per cent for health and hygiene, 3.37 per cent for education and around 10 per cent for recreation, tourism, tobacco and other non-essential consumption.68

Our research in Rio Grande do Sul has shown that overindebtedness in these lower-income households is a group or a family phenomenon (3 to 4 person per overindebted household). The IBGE research from 2003 also indicates that as a unit of consumption, the household in Brazil was counted as a group of 3.62 people, but in Southern Brazil, where our three researches were conducted, each household has an average of 3.33 people.69 There is also a slight feminization of poverty (55 per cent were women) in the results of this research.

We propose to overcome the difficulty of distinguishing poverty from overindebtedness as the source of problems by focusing more on the credit contract and its patterns as well as the economic capacity of the consumer to repay. So, if a credit contract was made without assurances (secured credit), as in 77 per cent of the cases, but with high interest rates, the new law should require proof that all commercial practices before the credit contract were scrutinized (aggressive or psychological marketing, abuse of the ignorance or illiteracy of the consumer), lack of disclosure or information about the total amount of the debt, and lack of other mandatory information in Art 52 of the Consumer Code, and provide as a penalty the automatic loss of all interest rates in case of an abusive practice. In addition, there should be a mandatory rule concerning calculation of the debt, with payments allocated initially to the principal amount and not the payment of interest, as is common in Brazil. This will help lower-income consumers to be able to repay. Also the French idea of ensuring a minimum amount of income for living expenses can help to ensure the dignity of the consumer during the payment plan. In this new Brazilian individual bankruptcy law the Defensores Públicos can act as pro-bono legal aid trustees of the bankruptcy.

B. The 2005 Rio de Janeiro Empirical Research: How to Include all the Creditors of a Middle-Class Consumer in Distress in Brazil?

The research in Rio de Janeiro city was conducted in 2005. Colleagues from the Defensoria Pública of Rio de Janeiro wanted to conduct the same research as in Rio Grande do Sul, but only in the capital city of that state. They began a pilot

68 IBGE—Despesa-Brasil, Despesa monetária e não monetária média mensal familiar—Brasil, 2003, in <www.sidra.ibge.gov.br/bda> accessed 15 January 2008. This result is similar to a 2002 research made in Canada with low-income households (circa 30% for housing, lease of homes or habitation, 17% for food, 4% clothing, 4% taxes, 45% others, such as transportation, 3.35% health and hygiene, education, recreation, tourism, tobacco and non-essential consumption. (Industrie Canada, Carrefour des consommateurs, slide 23, 12).

project about global renegotiation and payment plans for consumers in economic distress in the city of Rio de Janeiro in 2005 and 80 global renegotiations were made with 80 per cent success. Rosângela Cavallazzi (UFRJ) and Heloisa Carpena (MP-RJ) organized the academic research, studying 32 of these consumers.70

The purpose of this project was to reach the middle class in Rio de Janeiro and concentrate on the responsible credit and disclosure rules to prevent overindebtedness and the role of the Defensoria Pública as an alternative dispute resolution (mediation) forum to solve voluntarily consumer bankruptcy cases.

The first part of the interviews also aimed at delineating the profile of this individual consumer in distress or overindebtedness. From these 32 cases, the main results are the following: 53 per cent males, 56 per cent were married or living with a partner (married, 42 per cent, ‘uniões estáveis’, 5 per cent), 63 per cent between 35 and 55 years old, 65 per cent had completed college or university education, 58 per cent had more than five minimum wages in their household budgets per month (45 per cent class C and 13 per cent class B). Forty-one per cent of the households had three or four people.71

The second part of the interview in Rio de Janeiro was about the debt and its patterns: 38 per cent of the consumers had debts with only one creditor, 34 per cent with two or three creditors, 10 per cent with four creditors and 17 per cent had five or more creditors. So we can conclude that the middle class has debts with more creditors, which can make global renegotiation more difficult than for the lower-income consumers researched in RS. The type of creditor was: 46 per cent banks, 23 per cent financial enterprises and credit card companies, 10 per cent supermarkets, and 13 per cent others, such as department stores, large retailers and universal services, for example telephone, energy etc.

The third part of the interview concerned the legal issues. The 32 consumers that were in the Defensoria Pública had already asked for help before: 30 per cent tried to reach an agreement with the creditor, 37 per cent tried using the PROCONs, 10 per cent the small claims tribunals, without success. Sixty-seven per cent of lower income consumers tried to get an agreement or a renegotiation with the creditor without success in Rio Grande do Sul: with the middle class it was only 30 per cent, and more than 37 per cent filed in the administrative mediation system PROCON, showing a higher degree of awareness about their rights as consumers. We can also conclude that a majority of men (53 per cent) are more willing to fight for their rights, as opposed to the 55 per cent of women in Rio Grande do Sul. In any event no success was possible, which demonstrates how the law protects creditors’ rights in Brazil and a successful mediation is very unlikely, if the debtor has assets.

71 See also RL Cavallazzi, ‘O perfil do superendividamento: referências no Brasil’, in Marques and Cavallazzi (eds), Direitos do consumidor endividado: superendividamento e crédito (São Paulo, Editora RT, 2006), 376 ff.
The results here concerning the effect of Art 52 disclosure were almost the same as in Rio Grande do Sul, but 30 per cent of the creditors in Rio de Janeiro gave some advice about other options and different types of credit to the consumer: in 83 per cent of the cases the creditor did not calculate the total amount of the debt (13 per cent did calculate). The copy of the contract was given before signature only in 23 per cent of the cases (not provided in 77 per cent of cases). We conclude that Art 52 of the Consumer Code has very limited impact in providing fairness and disclosure in consumer credit for the middle class of Rio de Janeiro, but better than for the lower-income class from Rio Grande do Sul.

Creditors in Rio de Janeiro review the income of consumers before the signature of the contract in only 39 per cent of the cases. For these middle class consumers security was required in only 12 per cent of cases (88 per cent gave no security at all), showing that the confidence of the creditor in repayment is very high in relation to the middle class. A new bankruptcy law allowing middle class consumers to file bankruptcy may change these practices and result in more concern about responsible information and credit disclosure for creditors dealing with the middle class in Brazil.

The most important lesson in this empirical research in Rio de Janeiro was the difficulty for the good faith consumer in reaching agreement with all the creditors. Indeed the creditor with security does not want to participate in any negotiation. Only 30 per cent of middle class consumers tried to reach an understanding with the creditor, but they did not get a response, because the creditors’ legal situation was too secure. On the other hand, the middle class in Rio de Janeiro began to rely on credit to renegotiate their debts on their own their debts. Indeed, when the state failed to help, credit (withheld credit, wage assignments and credit cards) is used as a substitute for the public support program, what Iain Ramsay calls ‘credit card welfare: the idea of credit card as insurance.’72 This is only possible in middle class households, so it is our opinion that Brazil needs—like other jurisdictions—a bankruptcy law for individual consumers.

Our idea is that when the consumer files for bankruptcy all the special assurances (secured credits) of the creditors should be suspended and also all payments, so a mediation will be more attractive for the creditors. In 30 to 40 days creditors could come to an informal negotiation with the consumer in the Defensoria Pública and propose a payment plan that preserves their security and drops the bankruptcy action. Only after this period of ‘moratorium’ will the bankruptcy committee examine the case of the consumer and propose a global payment plan.

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C. The 2007 São Paulo Empirical Research: How to Deal with Unemployment and more than 200 per cent Increase in Debts and Make a Payment Plan for the Overindebted Consumer

The São Paulo data are from a small empirical research study, specially made for the Law and Society Meeting, but its results prove to be very significant when compared with the two studies, especially in the economic data about the rate of increase of individual debt in Brazil.

As already noted in Section I, in 2006 our research group decided to organize in 2006 a research project in the city of São Paulo. This was a mixed research among the lower-income and middle class in São Paulo (58 per cent of the consumers have as income two to four times the minimum wage and 33 per cent seven or more times the minimum wage per month, so from the classes B and D of the Brazilian population).

The profile of this individual consumer in distress or in overindebtedness is as follows: 52 per cent were males, 50 per cent were unmarried, divorced or widowed (47 per cent were married or living with a partner), 71 per cent were between 30 and 50 years old, 34 per cent unemployed, 19 per cent self-employed or from liberal professions, 3 per cent retired (and 37 per cent public servants). 47 per cent of the households have more than four persons.

About the debts, their patterns and the role of the marketing: 13 per cent of the consumers have debts with only one creditor, 13 per cent with two, and 26 per cent with three creditors, but 47 per cent have four, five or more creditors. Here the conditions are similar to Rio de Janeiro, with a large number of creditors per consumer. The type of creditor shows this plurality of creditors: 89 per cent of consumers have debts with banks, and 50 per cent also with credit cards, 50 per cent with financial providers and only 18 per cent with department stores and large stores; the rest was to pay friends, energy and water costs, telephone etc (circa 16 per cent).

The most common causes of indebtedness in this group of consumers were: unemployment (56 per cent) and divorce (11 per cent), and only 7 per cent indicated abuse of credit. The role of marketing was also investigated. Consumers gained knowledge about credit through: flyers and marketing personnel on the street (28 per cent), television and radio (16 per cent), direct mailing and e-mails (12 per cent), door-to-door marketing (2 per cent), and 42 per cent of the consumers indicated that at the supermarket, bank or big store they received information about credit at the supermarket, bank or big store.

The consumers that were in the PROCON-SP: 61 per cent tried to reach an agreement with the creditor, 32 per cent tried in other PROCONs, 5 per cent in the small claims tribunals. That 61 per cent (in Rio Grande do Sul the rate was

73 See about the unemployment, C Frade and S Magalhães, ‘Sobreendividamento, a outra face do crédito’, in Marques and Cavallazzi, Direitos do consumidor endividado: superendividamento e crédito (São Paulo, Editora RT, 2006), 20 ff.
67 per cent) of the consumers tried to get an agreement or a renegotiation with the creditor without success is again a very significant piece of data about how the law protects the creditors’ rights in Brazil.

About Art 52 of the Consumer Code, the results were that in 72 per cent of cases the creditor did not calculate the total amount of the debt (28 per cent did calculate). The copy of the contract was given to the consumer only in 41 per cent of the cases. It is interesting to note that in this research 60 per cent of the banks did not provide a copy of the contract and 70 per cent of the credit card companies also did not provide a copy of the contract to the consumer. We can also conclude that Article 52 of the Consumer Code has almost no positive impact in the imposition of fairness and disclosure in consumer credit in São Paulo, with lower-income lower middle class consumers. Creditors review the consumer’s income before signature of the contract in only 34 per cent of the cases, but do not ask for assurances (only 23 per cent of the creditors make requirements of security or secured credit), suggesting an absence of responsible credit behavior.

In this research in São Paulo the economic data have shown us that the rate of increase of the individual debt was between 101 per cent and 200 per cent in 31 per cent of the cases, and between 201 per cent and more than 400 per cent in 45 per cent of the cases. The high annual interest rates can be responsible for this rapid increase of individual debts, but also a new subprime market in Brazil may be the explanation. In the context of high unemployment rates, fragile labor markets and more than 200 per cent annual increase in individual debts, it is a very difficult task to create a rescue and restructuring tool or to make an efficient payment plan for consumer overindebtedness.74

D. Concluding Remarks: the Lessons Arising from the Empirical Studies, the New Easy Consumer Credit in Brazil and the Need for a Legal Response to the Explosion of Debts and Overindebtedness of the Individual Consumer

In 2004, an inquiry made by the most important daily newspaper in Rio Grande do Sul, Brazil concluded that in Rio Grande do Sul 82 per cent of lower-income consumers prefer to pay cash or to make savings to buy goods later.75 In 2007, the situation is different and the lower-income consumer begins to be seduced by the easy credit targeted to him in Brazil, as we saw in our first thesis about the credit explosion.

This new ‘easy’ credit accessible to all consumers (including from the classes C, D and E) means that the 55 per cent who are poor (but not the 22 per cent

74 See also JJ Kilborn, ‘Comportamentos econômicos, superendividamento, estudo comparativo da insolência do consumidor: buscando as causas e avaliando soluções’, in Marques and Cavallazzi, Direitos do consumidor endividado: superendividamento e crédito (São Paulo, Editora RT, 2006), 55 ff.
poorest) are very endangered. The researches have shown that there are no special disclosure or care or good-faith practices which effectively protect this part of the population: on the contrary, the legal results were the worst. In our opinion, this lack of concern for poor consumers, allied with the actual explosion of credit and debts by lower-income consumers, is preparing for an explosion of consumer overindebtedness. In a classic text, the French author Calais-Auloy called for five reforms that would make credit less dangerous to consumers.\textsuperscript{76} We need much more in Brazil. When ‘indebtedness becomes overindebtedness this has consequences for the individual consumers, the creditors and society as a whole.\textsuperscript{77}

If we compare the results of the three empirical researches conducted in different regions of Brazil we can verify that the Consumer Code and in particular Art 52 were not enough to prevent consumer overindebtedness, especially among lower class consumers, and its positive effects were overestimated in the middle class of São Paulo and Rio de Janeiro. We need a courageous legal response to the actual consumer credit explosion and growing individual overindebtedness in Brazil; we need consumer bankruptcy legislation.

The analysis of the empirical research in Rio Grande do Sul, in Rio de Janeiro and in São Paulo helps us conclude that the cultural and economic diversity in Brazil requires an adaptation of the French model of the treatment of consumer bankruptcy. Brazil should try to prevent overindebtedness, controlling commercial practices, including credit advertising, and imposing penalties for irresponsible (or reckless)\textsuperscript{78} credit, including discharge of the debt. The new law should promote voluntary renegotiations or agreements, always with the presence of the State, through the Defensores Públicos, PROCONs, small claims or the judiciary. We already have already written about the specifics of this new bankruptcy law for Brazil,\textsuperscript{79} but we want to stress that a flexible overindebtedness commission seems the most important feature of such reform. The bank and credit card industry must take part in this commission and help with the calculation of the payment plan, which should be no longer than five years, followed by a discharge.

Perhaps also a new consumer credit policy or law will be necessary, creating the right to apply for credit, the right to have a bank account and some usury control of interest rates. It will be also very important to classify differently the kind of credits, so that a new consumer policy is necessary to regulate the wage assignment and the pension assignment (Crédito consignado) and also the pu-


\textsuperscript{77} G Howells and T Wilhelmsson, EC consumer Law (Dartmouth, Ashgate, 1997) 223.

\textsuperscript{78} Reckless credit is defined in the South African 2005 National Credit Act, in Part D, sections 79–81. This seems to be a very interesting concept. In Brazil reckless credit or irresponsible credit should be when at the time that the credit contract was made, the creditor failed to conduct himself with fairness, disclosure and cooperation in good faith.

\textsuperscript{79} See our introduction and articles in Marques and Cavallazzi, 1 ff.
Public housing loans in the so-called Housing Finance System (Sistema Financeiro da Habitação), because they are public interest credit contracts.

At the end of this Chapter, we want to recall the words of Radbruch,\textsuperscript{80} that the concept of person or individual (Menschenbild) that each legal system has is the most important way to know the values of this legal system. Brazilian law must evolve to increase the protection of the individual consumer when in economic distress or overindebtedness. With the explosion and democratization of credit to all consumers, there are no reasons to keep bankruptcy as a privilege only for businessmen. The dignity of the person in an emergent state like Brazil must take into account access to credit and rehabilitation of the consumer. Brazil needs a new bankruptcy law\textsuperscript{81} for individual consumers that permits relief to the honest debtor from the weight of oppressive indebtedness and allows him or her to be included again in the consumer market.


\textsuperscript{81} There is already a draft in the Senate to change the current bankruptcy law which includes bankruptcy. A better way could be, like in South Africa, to enact a totally new law from the viewpoint of consumer law.
‘Wannabe WAGS’ and ‘Credit Binges’: The Construction of Overindebtedness in the UK

IAIN RAMSAY

New Labour has spent ten years presiding over an avalanche of unprecedented personal debt: fuelling the economy with consumer madness, teaching 18 year olds that owing tens of thousands is cool, making insolvency easier, promoting lotteries and casinos, sucking up to the super-rich and forgiving its friends for financial sins.

Libby Purves, The Times, Tuesday 20 July 2007

The borrowing party is over. We must face the pain or the hangover will be fearsome.


I. AFTER THE FALL: PRELIMINARY THOUGHTS

A COMMON REFRAIN, EVEN before the credit crunch, was that during the past decade UK consumer credit markets exhibited ‘irrational exuberance’ by lenders and a ‘credit binge’ by consumers. ‘Britain is in the grip of a credit binge’, stated Deirdre Hutton, Chair of the National Consumer Council, in 2004 to the British Bankers Association, regaling her audience with the story of a nine year old being offered a credit card with a £10,000 limit. The Guardian ran several stories on the ‘unsustainable borrowing binge’ between 2001 and 2005. A Guardian journalist who filed for personal

1 This is a preliminary part of a larger study. Thanks to Toni Williams for comments and to Mike Rutherford, Cecilia Parker and Alberto Salazar Valle for research assistance. The author is grateful to the Social Sciences and Humanities Research Council of Canada for financial support of the research.


3 ‘Binge’ is used also in relation to overeating and problem drinking in the UK. Analysis of The Guardian newspaper during the period 2001–2005 indicates that during this period a theme in articles on debt and credit was the ‘unsustainable borrowing binge’ (15 articles out of 52 on debt and credit).

4 The Guardian ran over 50 articles on debt and consumer credit between 2001 and 2005. Fifteen of these articles refer to the ‘unsustainable borrowing binge’ and there are references to ideas that
bankruptcy confessed that although bankruptcy was ‘horrible . . . [w]hat helped me through was the knowledge that I was not alone. I knew numbers of domestic bankruptcies had multiplied because of a growing debt culture’ (emphasis mine). Michael Kitson and Frank Wilkinson in their review of New Labour economic policy conclude that economic growth under New Labour was ‘sustained by high levels of consumption, which has been driven by easily available credit, which in turn has led to high levels of debt and insolvency . . . [d]emand has been driven by a consumption binge . . . but the hangover may be worse’.

While these concerns about overindebtedness may not represent a moral panic—the closest to a ‘folk-devil’ in popular and parliamentary discourse being the credit card—the media concern represented a (perhaps justifiable) anxiety about high levels of credit. The UK broadsheets also expressed concern at the ‘sharp’, ‘soaring’ and ‘alarming’ rises in personal insolvency. The articles cited two causes for the rise: high personal debt and the Enterprise Act 2002 which reduced the discharge period to one year for first-time bankrupts. Some articles criticise debtors for taking on too much credit and identify the ‘lifestyle bankrupt’. The majority believe that the stigma of bankruptcy has lessened and that changes in legislation have contributed to this. Most viewed bankruptcy as negative rather than as a ‘fresh start’ for the debtor. Tabloid newspapers such as the right wing Daily Mail quoted ‘experts’ as arguing that individuals using Individual Voluntary Arrangements (IVAs) (a form of debt composition) were ‘living beyond their means’: a sign of the ‘spend not save culture’. They also argued that there is a group of young single women (20–30s) who want to ‘have it all’ and have loaded up on credit cards for ‘clothes, socialising and holidays’. The Daily Mail claims that ‘women who yearn for the life of a footballer’s wife are causing a surge in female bankruptcies’ and that these Wannabe WAG’s (wives and girlfriends) represent a new type of bankrupt.

‘attitudes to debt’ had changed while borrowers are accused of having a ‘carefree’ attitude. There is also the theme of aggressive lenders and the targeting of vulnerable consumers. The ‘crackdown’ on loan sharks recurs and 10 articles refer to the Meadows case where an initial debt of £6,000 spiralled to £380,000 and where the debt was ultimately struck down on technical grounds rather than because the bargain was extortionate. See London North Securities Ltd v Tony James Meadows & Anor [2005] EWCA Civ 956 (27 July). The New Statesman ran a series of articles on ‘The Debt Pandemic’ (24 October 2005).

7 Classic moral panics include the creation of a ‘folk devil’ such as a supposedly deviant sub-culture (mods and rockers etc) constructed as a threat to society. See S Cohen, Folk Devils and Moral Panics 3rd edn (London, Routledge, 2002).
8 Articles on personal bankruptcy and insolvency in the UK broadsheets have increased in recent years. In 2002 there were 4 articles; 2003, 10; 2004, 17; 2005, 32. The Financial Times was the largest publisher of articles on personal bankruptcy (16 in 2002–2005). The main theme was the ‘sharp’ or ‘soaring’ or ‘alarming’ rises in personal insolvency.
9 B Barrow, ‘Going bust, the wannabe WAGs’, Daily Mail, 21 August 2006. See also ‘Rapid rise in women declaring themselves bankrupt’, Daily Mail, 8 August 2007 where the rise is attributed to ‘the number of women racking up unmanageable debts [and] feeling under increasing pressure to maintain lavish lifestyles’.
From these accounts something had changed in UK culture. Individuals no longer resembled the 1950s characters in Ian McEwan’s novel *The Innocents* who shunned credit and were saving hard for a much-desired television ‘having sensibly set their hearts against hire-purchase’. UK society has apparently undergone a social transformation towards a society where credit—and the usual symbol is the credit card—has ‘exploded’ and individuals are comfortable with high levels of debt that are potentially dangerous should there be any disruption to their earnings or external shocks from large interest rate increases. Consider the following not untypical evidence by a bankruptcy professional to a Parliamentary Committee:

My view, which is based on examination of cases both as an adviser and as a deputy bankruptcy judge in the High Court, is that the increase is a result of the increase in consumer debt and the number of people who cannot cope with it. On an average day in the High Court in London, one would see about 20 cases of debtors, whereas a couple of years ago there would be four or five on an average registrar’s list . . . It is difficult to see that any of the debtors in such cases are in any sense entrepreneurs. They fit into the perspective that has been given of males aged 20 to 40—the average age of debtors must be coming down. They certainly have no capital assets or assets that they are going to lose in bankruptcy. Some are unemployed but many are employed and certainly have debts that are out of control. In the overwhelming majority of cases, the debts are consumer debts from endless credit cards that have hit the limit, and with which the debtor can no longer cope. (Emphasis mine.)

Adopting a simple base/superstructure approach one might account for these changes through: (a) the changes in and increasing dominance of global finance capital since the 1970s; (b) the consequent restructuring of regulation to facilitate consumer lending including practices such as securitisation and computerised risk-based lending; and (c) the accompanying dominance of neo-liberal ideology and a credit culture. In the inevitable crash after the unsustainable boom, ordinary consumers suffer most and finance capital will regroup and move on to more profitable terrain (India, China, Brazil?). While this seems both highly schematic and reductive its general outline is reflected in Larry Elliott and Dan Atkinson’s *The Gods that Failed* and David Harvey’s *A Brief History of Neo-Liberalism*. Harvey argues that neo-liberalism in the UK, represented by the opening up of the financial services market, permitted a flourishing consumer culture and brought ‘more and more of a debt culture into the centre of a formerly staid British life’.

A focus on the UK may, however, overlook different forms or varieties of capitalism. UK credit practices follow the US—payday lending and credit card practices are two examples—and the UK provides the stalking horse in Europe

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for US models of credit. The US and UK may favour a consumerist rather than producerist model where the objectives of policy include low prices, shopping convenience and easy access to credit: France and Germany in contrast may be more sceptical of the values of unrestricted consumer choice. There may also be reservations in some countries about an economy driven by consumer credit. There are significant differences in both the levels of consumer credit and forms of credit regulation between the UK and France and Germany. Udo Reifner contrasts the neo-liberal UK approach which relies primarily on informed consumers and responsible lending and the ‘social market’ approach in other European countries with ‘usury ceilings, capped default interest rates, protection against early termination and discharge, [and] warnings and information on debt’. Within the latter model individuals are to be protected from credit as a potentially dangerous product. There are certainly tensions between these approaches in the EU as it attempts to balance the neo-liberal policy embodied in the Consumer Credit Directive with concerns about financial exclusion and overindebtedness.

The growth of consumer credit in the UK and its accompanying costs, such as overindebtedness, did create pressures for regulation during the 1990s and the Labour government had promised to tackle loan sharks in its 1997 manifesto. Consumer interest groups such as Citizens Advice highlighted the apparently large growth in overindebtedness as measured by the increase in debt problems brought to its advice centres. Since the late 1990s there have been a flurry of official reports and task forces on credit, debt and insolvency. In 2000 an overindebtedness ‘summit conference’ was held, followed by the establishment of a task force and a subsequent governmental overindebtedness strategy. This strategy proposed an ambitious combination of measures to prevent and treat overindebtedness. The objectives included assuring affordable credit, embedding responsible lending through a new consumer credit regime, encouraging a savings culture to avoid overindebtedness, and the provision of high-quality debt advice. The ‘keys to the achievement of these goals’ included the develop-

13 This theme is not new or restricted to consumer credit. In 1989 the Office of Fair Trading suggested that a ‘credit society’ had developed in 1979 when outstanding credit exceeded new credit extended for the first time ‘so creating apprehensions about “overindebtedness” and the emergence of a “credit society” which, some thought, brought this country closer, even if belatedly, to American behavioural norms, than for example those of other members of the European Community’. Office of Fair Trading, *Overindebtedness—A Report by the Director General of Fair Trading*, at 8.


16 See the current EU project DG Employment, Social Affairs and Equal Opportunities, Towards a Common Operational European Definition of Over-Indebtedness (2008). See also Sefa Franken, this volume, ch 7.

ment of financial capability among the population, increases in credit unions, the development of alternative forms of affordable credit, and the introduction of a stakeholder suite of savings products. Consumer credit reform would beef up credit licensing, tackle illegal moneylenders, improve data sharing to promote responsible lending, provide better debt advice, improve insolvency procedures through a Debt Relief Order for low-income individuals with no assets, reform Administration Orders and strengthen repayment schemes. These priorities were underpinned by the government’s aim to both create an efficient credit market and to ‘advance equity in line with the Government’s wider social justice agenda’. These proposals included several distinct policy communities and government departments, and make the assumption that overindebtedness is a problem that can be solved.

The opposition Conservative party also identified overindebtedness as contributing to their claim that the UK was a ‘broken society’. They sponsored a Commission on Debt which reported in 2005 that ‘personal debt is the most serious social problem facing the UK’.19 Throughout this period parliamentary committees denounced the marketing practices and late fees charged by credit card companies commenting that ‘irresponsible marketing can give an impression that taking on debt is painless’20 and the major consumer agency in the UK (the Office of Fair Trading) took high-profile action against late and penalty credit card fees resulting in an across-the-board reduction in fees.21 The Competition Commission held the sub-prime ‘home lending’ market and the retail store credit card market to be anti-competitive,22 the Financial Services Authority criticised practices in the sub-prime mortgage lending market,23 and the government developed high-profile initiatives to attack illegal loan sharking. The Consumer Credit Act 2006 introduced ‘irresponsible lending’ as a ground for the potential revocation of a credit licence, an ‘unfair credit relationship’ test, and a battery of new disclosures throughout the life of a credit contract including warnings on making minimum payments on credit cards. The

18 Ibid at para 1.12.
21 See OFT, Calculating Fair Default Charges in Credit Card Contracts 842 (2006). The OFT suggested a fee of £12 (many existing fees were £25) and this was adopted by almost all credit card companies.
Banking Code, a form of ‘audited self-regulation’, was reformed to include responsible lending throughout a credit contract.

It is difficult to assess the long-term effects of this contemporary reform of credit regulation. The impact of the credit crunch on general credit availability may in retrospect make the policy effects of responsible lending initiatives appear like re-arranging the deck chairs on the Titanic. But it is possible that the credit crunch will provide the opportunity for reform of the UK model of consumer credit. The overindebtedness strategy reflected New Labour’s attempt to combine markets with social responsibility—hence the emphasis on responsible lending and responsible borrowing. But many of the current reforms originate from policy documents of the 1980s and the modernisation of the Consumer Credit Act 1974 by the 2006 Act addressed criticisms that had long been circulating in relation to both the credit licensing regime and the discredited ‘extortionate credit bargain’ test for attacking consumer credit contract provisions.

The current UK strategy might be understood in terms of policy making in neoliberalism where the state cannot depend on a self-regulating market and is often in the situation of being under pressure to regulate markets, respond to crises and ensure the legitimacy of the financial system. Harvey argues that there is the ‘paradox of intense state interventions’ in a world where the state is supposed not to be interventionist. A leitmotif in the overindebtedness strategy is that if only the concepts of responsible lending and borrowing take hold then government regulation will be necessary only for the rogues and sharks—the unscrupulous operators. But given Harvey’s argument about the continuing need to regulate in response to crises and outrages it is likely that there will be continuing demands to regulate, particularly where there are, as in the UK, vast differences in the terms of credit available to affluent and poor consumers.

The distributional consequences of the contemporary reforms are unclear but consumer credit poses a challenge for contemporary capitalism since an abiding concern here is distributional—that the poor pay more. A fairness agenda—embedding credit markets within norms of fairness—may provide benefits to low-income consumers but ultimately fail in ensuring that credit is available on similar terms to both low and middle income consumers.

II. CONTEMPORARY CONSTRUCTIONS OF OVERINDEBTEDNESS

Explanations of overindebtedness in the immediate aftermath of the credit crunch portray an era of bingeing and excess that led to the credit crunch. It is often repeated that ‘we’—UK households—have been living beyond our means. But the pre-credit-crisis empirical data were equivocal on the existence of a debt crisis. First, the Bank of England noted in 2006 that there ‘has been relatively little change since 1995 in the proportion of households saying that their
unsecured debt is a burden’. In 2007 only 8 per cent of mortgagors reported problems paying their mortgages, half the percentage reporting difficulties in 1991. One recent study concludes that ‘heavy credit use is concentrated among a tiny minority of the population’. Second, the profile of those most likely to default on their loans had not changed dramatically since the 1980s, with low-income individuals, younger debtors, those who rent rather than own, and single parents being more likely to experience debt default. A caveat to these data is that individuals underestimate their levels of debt in responses to surveys. Third, the use of personal insolvency and debt management plans had increased substantially since 2003 but was not perceived by government reports to represent a crisis. Finally, attitudes to credit in 2002 were similar to those in 1979 with a substantial majority of respondents indicating that credit was either never a good thing or occasionally necessary. This finding raises intriguing questions about the nature of a ‘debt culture’ where substantial credit use co-exists with anxiety and distrust about its use.

A different story to that of a ‘credit binge’ would emphasise the following points. The era since the 1970s has been characterised by relatively slow growth, with many individuals using credit to bolster stagnant disposable incomes or relying on credit to address job insecurity. Financial crises have been more frequent—Kindleberger and Aliber argue that the period since the 1970s has been unprecedented in terms of the frequency and severity of financial crises. The extension of credit—represented by the populist slogan of the democratisation of credit—may have permitted more individuals a ‘taste of the pie’ during this period but the UK evidence is that the shares of the pie have become more unequal.

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24 M Waldron and G Young, ‘The state of British household finances: results from the 2006 NMG Research survey’ (London, Bank of England, 2006). ‘There has been relatively little change since 1995 in the proportion of households saying that their unsecured debt is a burden. Around one in ten households with unsecured debts found them a heavy burden, and around one in four found them somewhat of a burden (Chart 7) . . . The relative constancy since 1995 in the proportion of debtors saying their unsecured debt is a burden contrasts with the sharp rise in the proportion of households becoming insolvent over this period.’


26 See Personal Finance Research Centre, Easy Come Easy Go: Borrowing over the life-cycle (Bristol, PFRC, 2007).


28 Oxera, Are UK Households Over-Indebted? (2004) has pointed out that ‘there is a substantial difference between the ‘grossed up amount of debt provided in surveys and that reported by credit providers’. Individuals may underestimate their level of debt and whether they are in financial difficulty.


30 See Kempson, Overindebtedness in Britain (2002) at 19.

over the past 25 years.\textsuperscript{32} Returning to the \textit{Guardian} journalist whom we introduced earlier, her description of the causes of her bankruptcy are instructive:

[\textit{W}hen I became the subject of a court order and admitted to an official receiver that I'd been living beyond my means, I was gratefully humbled . . . \textit{[But I]} refute the inevitable assumption that I was a spendthrift. The money went on supermarket shopping when my wages had run out, on petrol, car repairs and basic furniture for the small rented home I shared with my husband. We did not live a life of excess, but we did live in excess of our incomes.

The idea of a contemporary ‘culture change’ in relation to debt—towards a ‘live now pay later’ culture—overlooks the fact that consumer credit and debt are not novel phenomena: it is not clear when we should identify the significant change in culture to a ‘credit culture’. One might periodise from the early 1970s when initial deregulatory steps were taken in relation to the supervision of bank lending. In addition the Consumer Credit Act 1974 was intended to facilitate and legitimate the growth of the consumer credit market. Many of its provisions were based on the Crowther Committee’s recommendations, whose starting point was that ‘the state should interfere as little as possible with the consumer’s freedom to use his knowledge of the consumer credit market to the best of his ability and according to his judgment of what constitutes his best interests . . . it remains a basic tenet of a free society that people themselves must be the judge of what contributes to their material welfare.’\textsuperscript{33} The Act was intended to provide fairness through the elimination of the fly-by-night operators who primarily exploited vulnerable consumers. Large credit grantors openly welcomed the Crowther Committee’s proposals on which the Act was based; regulation would help develop the market.\textsuperscript{34}

This periodisation of the growth of consumer credit from the 1970s should not make us overlook earlier periods of consumer credit. During the 1920s and 30s there was a boom in hire-purchase as consumers purchased radios, cookers and vacuum cleaners on credit. At the end of the 19th century £10 pianos were being offered on ‘easy terms’ of as little as 1s 6d a week.\textsuperscript{35} Margot Finn has charted the importance of forms of credit in the expansion of consumption in 18th- and 19th-century England, its important role in working-class life, and constituting and maintaining social and economic class differences.\textsuperscript{36}

\textsuperscript{32} The idea that credit has provided a taste but not a share of the pie is made in relation to credit cards in the US in R Manning, \textit{Credit Card Nation: The Consequences of America’s Addiction to Credit} (New York, Basic Books, 2000) at 124.

\textsuperscript{33} \textit{The Report of the Committee on Consumer Credit} (The Crowther Committee) (1971) Cmdn 4596 at 151.

\textsuperscript{34} The Committee described the ‘rapid growth in consumer credit in Britain since the end of the Second World War’ and the ‘community’s ambivalent attitude to the emergence of this relatively new phenomenon’. \textit{Ibid.} at 116.


\textsuperscript{36} M Finn, \textit{The Character of Credit: Personal Debt in English Culture, 1740–1914} (Cambridge, CUP, 2003).
It would be naïve to make simple comparisons between these differing historical periods. For example, the extent of credit and the number of transactions financed through the formal credit system was substantially less during the 1930s than the 1980s. There are, however, recurring historical social anxieties about credit and debt. Hire-purchase apparently led ‘young people to make early and improvident marriages’ during the 1930s.³⁷ Barbara Weiss concluded that in 19th-century England bankruptcy was seen by novelists as ‘a symptom of social disintegration, of a world that was losing its sustaining ties of community, stability and order’.³⁸ In late 18th-century England credit was ‘blamed for promoting extravagance and encouraging fecklessness. It was alleged to cause individuals to lose a sense of who they were and what they could and could not afford, and to lead them to replace thrift and careful saving with the immediate gratification of trivial or even improper desires’.³⁹ There was often a gendered aspect to the siren call of credit—as in Daniel Defoe’s Lady Credit—and bankruptcy’s association with irrationality, weakness and impulsiveness⁴⁰ threw up the imagery of the loss of ‘manliness’ to signify a bankrupt’s condition.⁴¹

Lendol Calder, in his history of instalment credit in the US, is sceptical of the ‘reality’ of recurring US historical anxiety about debt. In his view they take a standard form with a description of the massive amount of consumer debt outstanding; the potential demise of the ethic of thrift—a lost era of virtue—that was held by earlier generations; equal criticism of the aggressive practices of credit sellers and consumer hedonism that is turning the country into a nation of bankrupts; and finally a fear about the disastrous economic and social impact of overindebtedness on the economy should there be an economic downturn.

He argues that credit has been in fact a highly successful disciplinary force in modern society where the vast majority of individuals learnt the discipline of the instalment plan and monthly payments. He also describes the ‘normalization of consumer credit’ in the 1920s and 30s in the US.⁴² By this he means the conscious attempt to legitimise the use of credit for consumption rather than production through influential studies, such as Edwin Seligman’s The Economics of Installment Selling, which was commissioned by General Motors and through shifts in the views of ‘opinion leaders’, such as the American Bankers Association, and middle-class magazines. His argument suggests a conscious

³⁷ P Johnson, Saving and Spending (Oxford, OUP, 1985) at 158.
⁴⁰ See, eg M Finn, The Character of Credit (Cambridge, CUP, 2004); M De Groede, ‘Mastering Lady Credit’, ch 2 in Virtue, Fortune and Faith (Minneapolis, University of Minnesota Press, 2005).
attempt to create a debt culture in the US as part of the development of consumer capitalism.

These historical notes pose the research question of understanding the similarities and differences between contemporary anxieties about overindebtedness and earlier eras’ concern and the role of influential groups in promoting a debt culture and anxieties about debt. They also underline the fact that credit relations are ‘permeated with cultural and moral assumptions’, and involve issues of class and gender. They raise the question whether the contemporary concern with debt and the ‘credit crunch’ will pass away leaving little mark on the normative landscape or whether they may result in long-term changes in legal and social policy concerning credit and debt or even the way society conceives itself. The adoption in the UK and the US of an economy driven by high levels of consumer debt, where the values of security and equality have been traded off for freedom of consumer choice and increased consumption alternatives, may be inherently unstable. This may be a message to the international ‘model mongers’ who promote the US model to developing countries.

The ‘credit binge’ story provides a justification for restricting credit in the future, demonstrating that lenders are ‘responsible lenders’. But the danger is that this approach will increase financial exclusion and the need for individuals to use sub-prime lenders. It may halt attempts to get banks to lend within lower income communities. There is little evidence that the poor have been bingeing on credit cards (see below) and it would be ironic if they are a significant victim of the crunch.

III. OVERINDEBTEDNESS AS A PATHOLOGY OF AFFLUENCE?

Social science studies in the UK since the 1970s drew attention to the connections between overindebtedness and issues such as unemployment. Overindebtedness was associated with lower-income individuals, single parents and low income. In some cases it represented the limits of welfare state provision. In his classic study of the enforcement of debts in the late 1960s, Paul Rock suggested three typologies of debtors which structured the debt collection process: the unfortu-

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43 Baudrillard writes: ‘Credit here plays a determining role . . . The idea is exemplary. Presented under the guise of gratification, of a facilitated access to affluence . . . and of “freedom from the old taboos of thrift, etc,” credit is in fact the systematic socioeconomic indoctrination of forced economizing and an economic calculus for generations of consumers . . . Credit is a disciplinary process which extorts savings and regulates demand—just as wage labour was a rational process in the extortion of labour power and in the increase of productivity.’ J Baudrillard, ‘Consumer Society’, in J Baudrillard, Selected Writings (Stanford, Stanford University Press, 1988) 49.


nate, the professional, and the feckless. The feckless classification reflected ideas of ‘irrationality, irresponsibility, impulsiveness and unpredictability’. Rock argued that the dominant social typification was moving towards a social work model of the debtor—where debtors are regarded as inadequate persons in need of treatment. This characterisation dovetailed with the work of the Payne Committee on the Enforcement of Judgment Debts who proposed a social service office for debtors as well as a state enforcement office.

However, the image of the unfortunate rather than inadequate debtor dominated social science studies during the 1980s and 1990s. In the major study by Berthoud and Kempson in 1992 they concluded that ‘consumerism’ was not the major cause of problem debt but rather the fact that many families were in a position where they faced grave difficulties in meeting basic obligations noting the ‘exceptional level of risk of serious debt for low income lone mothers’. The primary reasons for financial difficulties were loss of income through redundancy, relationship breakdown, sickness or disability and other loss of income (45%). A replication of this study in 2002 compared the reasons for financial difficulty in 1989 and 2002 (see Table 4.1 below). This continued to underline the importance of loss of income as a contributor to financial difficulties.

In recent years, however, both the popular media (see above) and some research suggest that overindebtedness may be increasingly a pathology of affluence affecting a large part of the middle class. The ‘feckless’ debtor has returned as the naïve and myopic borrower who lives beyond her means. In a small qualitative study of debtors who had consulted a Consumer Credit Counselling Service Elliott concluded that debtors had displayed a ‘naïve optimism’ and that ‘no borrower really appreciated the significant effect of interest and charges on the balance over time’. Studies of debtors undertaking IVAs suggests that ‘living beyond means’ is a significant cause of financial difficulties (34%) although reduction in income, breakdown in relationships and illness or accident represented 39% of the reasons. PriceWaterhouseCoopers, in their analysis of IVAs, comment that there ‘is no doubting that many debtors live beyond their means’ and conclude that ‘living beyond one’s means may be enough, eventually to force individuals to seek a financial settlement with his creditors’.

Do these studies support the ‘credit binge’ argument that appears in the popular and broadsheet press? This is difficult to assess because many of the individuals using IVAs also appeared to be from unskilled occupations who

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earned on average less than £20,000 and did not own their own home. It is unlikely that such groups would have substantial discretionary income and hardly fit the image of the ‘high-rolling’ debtor. Living beyond their means for this group sounds more like not ‘knowing their place’ in society and we should note the ambiguous nature of ‘living beyond means’ in the Guardian journalist’s account of her bankruptcy. If we maintain a caveat about the meaning of ‘living beyond means’—with its implicit judgmental quality—the studies do suggest that there are distinct routes into debt.

For some debtors problems with debt may be linked to low income combined with an upset to finances. A longitudinal study of low income and debt by Sarah Bridges and Charles Disney identified the source of substantial debt arrears as low income and economic inactivity. Tenants and one-parent families with children were at greatest risk. Whether debt became a long-term problem depended on whether ‘adverse economic characteristics such as single parenthood, economic inactivity, and low wages and so on are persistent’. Credit cards were not a problem for this group but rather the rising costs of utilities and housing. Over time the authors found that significant numbers of those on low income had improved their position and ability to access the mainstream credit market as they had grown older. The authors conclude that there is evidence of ‘significant arrears among a sub-set of families, but most arrears are not strongly persistent’. The policy implications of Bridges and Disney’s study are that measures ensuring predictable housing and utility costs and stable employment may reduce debt problems for low-income consumers.

Michael Green argues (see Chapter 19) that a distinction should be drawn between debtors in the working economy and those in the dependent economy and that distinct remedies should be crafted for those groups—with repayment plans as the norm for the former and debt relief orders the norm for the latter. While it may be difficult to draw this distinction consistently since Bridges and Disney point out that individuals move in and out of the dependent economy his distinction draws attention to the fact that overindebtedness may be both a pathology of affluence and of low income within an affluent society.

A sophisticated analysis of debt as the pathology of affluence is made by Avner Offer in his book The Challenge of Affluence. He argues that the enormous growth in affluence since the Second World War has undermined prudential norms. Drawing on behavioural economics he argues that myopia results in a favouring of short-term preferences over long-term. This bias has been promoted by government policies which favour choice in consumption over policies of security and equality. There are also distributional implications to these changes. Individuals may counter tendencies towards short-termism through a variety of pre-commitment devices such as automatic savings for pensions,


increased education and so on. However, these devices may be more available to better-off individuals who can create more stable life or career plans. Thus Offer views obesity as one of the pathologies of affluence, but it is a pathology which the poor face higher costs than the rich in combating.

Offer also points to the growth in inequality in both the UK and the US since the 1970s, the need for both partners to be in the labour force, and the increased competition around positional goods such as education and housing locations associated with good schooling. Offer argues that although there are many divergences between the UK and the US, the Thatcher project ‘deliberately set out to emulate the American model’ and it is ‘likely that the culture of restraint inherited from the past’ is ‘losing its value as a resource for coping with the permanent flow of novelty’. Offer references Elizabeth Warren and Amelia Warren Tyagi’s *Two Income Trap* in his discussion of the pressures on the US middle-income family and the dangers to this group of unemployment, health costs and marriage breakdown, with the large increases in personal bankruptcy representing the ‘fall from grace’ of many in this middle class. Warren and Tyagi do not, however, subscribe to the ‘overconsumption myth’—that families spend their money on ‘things they don’t really need’ or that consumers go ‘deep into debt to finance consumer purchases that sensible people could do without’. It is rather housing and education and the necessity for the two-income family to achieve the same level of disposable income as achieved by the single male breadwinner in the early 1970s.

Bridges and Disney draw attention to the problems of those on low incomes meeting day-to-day commitments. But there is also the issue of relative deprivation for those who are not poor in absolute terms. The need to fully take part in a society such as the UK results in a demand for cell phones, DVDs, videos, foreign holidays that places a burden on the finances of the relatively poor (which may include young consumers). And Warren and Tyagi underline the difficulties of individuals maintaining middle class norms. These observations suggest that a variety of policies may be desirable to address overindebtedness. They also undermine simple ‘bingeing’ stories about the past decade.

Offer does not provide any detailed policy prescriptions to address the pathologies of affluence. However, the behavioural revolution in policy analysis with the ascendancy of behavioural economics and influential books such as *Nudge* promise the possibility of shaping behaviour to avoid the scourges of affluence. This development represent the move to ‘governance’ in regulation where government increasingly views individuals as regulatory subjects who

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54 Ibid, at 365.
56 Ibid at 16.
57 Ibid at 16.
may be ‘guided’ to do the right thing by government policies such as disclosures which exploit behavioural biases, the alteration of default rules and the choice architecture which individuals face. The massive investment in the untested policy of financial literacy is an example of this approach.\(^6^0\) However, Offer’s point that class differences may affect the ability of individuals to counter short-termism and develop commitment devices may undermine the potential progressive distributional effects of financial literacy and other behavioural initiatives. There is little systematic analysis of the effects of behavioural nudges in the area of consumer credit.

IV. CONCLUSION

Models of credit regulation are based on assumptions about credit, debt and consumer behaviour. A focus on consumer irrationality in credit decision making or a belief that credit is a potentially dangerous product will result in a different institutional structure to a structure premised on the assumption that credit contributes to the alleviation of poverty and is generally a positive benefit to society. There is a danger in credit policy making that those who need credit may be denied it because of false assumptions about how they use or manage credit. Given the social anxieties and fears about credit in society policy must navigate between the Scylla of middle class moralisms and the Charybdis

of a belief that disclosures and financial literacy are the answer to debt problems. Excoriating our ‘want it now’ society or ‘credit bingeing’ will not provide a clear guide. It is unlikely that there will be convergence on a common international approach to consumer credit regulation as exists in competition policy. Attempts by international institutions to establish a consensus on ground rules for credit markets is likely to reflect controversial assumptions about credit and its role. It is therefore necessary to ensure that there is a proper dialogue on the role of credit within society. This may be difficult given the difficulty of bringing together and reconciling technocratic and populist views on credit.
I. PROCESS

BECOMING OVERINDEBTED IS usually a process. One can become overindebted overnight, and this is how one would like to describe the incident. It would be nice to state that one single event changed one’s life from ordinary to overindebted. One can become overindebted overnight because the housing market plummets exactly when one has to sell or when the relative for whose loans one has signed as a co-debtor files bankruptcy. But even in those cases one has to be heavily indebted already when the final, triggering incident takes place. The process has already started when the house was bought with credit or the loan was signed. But more often than not, the gliding into overindebtedness has a more typical process-like character. The first loan was reasonable, but then one takes another and a third and then one more. The living costs were under control in the beginning but after the car broke and had to be repaired and the mortgage payment was missed, one had to start to shop on credit. Somehow it all went out of control. Or mum fell sick and dad was downsized and the money was not the biggest problem. Or the firm that started so nicely lost business when the factory in the neighbourhood moved its production somewhere where the cost of labour is so much lower. Whatever the beginning, when the creditors started to collect, collection costs accumulated, default interests run and the situation became unmanageable.

Things like that happen in real life and the law cannot prevent most of the misfortunes that hit people and can lead to debt problems. There is, however, a widely spread belief that law can make the process of becoming overindebted more or less likely, quicker or slower, and perhaps in some cases even make the debtor change the course of events. There is also a belief that European law is less favourable for those becoming overindebted than American law. In believing so, we of course presuppose that there is something that can be called
European law in the relevant field of law, which is not self-evident, and we will come back to this issue at the end of this Chapter.

As the credit markets have opened and become international, also consumer credit has become international. As people shop on the net and while abroad and borrow money from foreign banks, they also become indebted to foreign creditors. The international communities, however, have been relatively slow in responding to the problems of overindebtedness. The collection of debts has transgressed borders especially in the European Union with the notion of ‘free movement of judgments’ but the protection of debtors was not recognised as an international concern until quite recently. In 2005 the Ministers of Justice of the Council of Europe adopted a Resolution on debt problems that included an initiative to draft an international document for the protection of overindebted debtors. They also commissioned the European Committee on Legal Cooperation (CDCJ) of the Council of Europe to do a study on overindebtedness. This process led to the adoption of a Recommendation by the Committee of Ministers in 2007; the first international document recognising the need for international co-operation in alleviating the problems of overindebtedness.

This Recommendation stresses the prevention of debt problems as a priority. Already the 2005 Resolution stated that a broad variety of measures are needed

1 In the comparative law a lot of attention has been paid to the distinction between common law and written law, a distinction present in the European context. In recent literature also other variations in the European legal culture have been recognised. See, eg, Th Wilhelmsson, E Paunio and A Pohjolainen (eds), Private Law and the Many Cultures of Europe (Netherlands, Kluwer Law International, 2007).


3 The European Union has already commissioned three studies on the matter; the first of them in the early 1990s. See N Huls, U Reifner and T Bourgoinie, Overindebtedness of Consumers in the EC member States: Facts and search for solutions (Diegem, Louvain-la-Neuve, Kluwer Editions Juridiques Belgique; Centre de droit de la consommation, 1994); U Reifner, N Huls, J Niemi-Kieslăinen and H Springeneer, on the Legislation relating to Consumer Overindebtedness in all European Union Member States (Hamburg, Institute of the Financial Services e.V., 2003). Towards a common operational definition of over-indebtedness, see http://www.pfrc.bris.ac.uk/completed_research/Reports/2008_EC_Over-indebtedness_Summ.pdf by Observatoire de l’Epargne Européenne, Centre for European Policy Studies and Personal Finance Research Centre.


to confront the challenge of growing debt problems. The Recommendation lists preventive measures, measures to alleviate the effects of overindebtedness and rehabilitative measures. Among the preventive measures, advice and counselling, financial literacy programmes, promotion of responsible credit practices, use of credit data and other information as well as the safeguarding of the rights of guarantors are mentioned. The alleviation is mainly connected to the protection of the debtor’s rights in the enforcement processes, and the rehabilitation includes both legal and voluntary debt settlement and payment plan schemes.

The aim of preventing debt problems was emphasised throughout the process of drafting and preparing for the Recommendation. Preparing for the 2005 meeting, the Finnish Ministry of Justice gathered information from the member states of the Council of Europe on the laws covering overindebtedness. The survey was based on a broad approach to processes leading to overindebtedness and it included questions on debt counselling and advice, credit data collection and registration, debt enforcement and rehabilitation procedures. The author of this chapter was requested to report the results of the survey in 2005 and to propose adequate measures. In this chapter we present the main findings of this study.

The report did not cover all relevant legislation governing debt relations, even if it was closely connected to the process of overindebtedness. There were several considerations behind this delimitation of the study. First, the focus of our study was on the process of overindebtedness and the regulations immediately relevant for that process. Secondly, the regulation of consumer credit was under serious consideration and debate in the European Union, with the purpose of harmonisation of the regulation. Thirdly, the assessment of all law relevant to the process of overindebtedness would include a great variety of regulations besides consumer credit, especially personal guarantees for loans (co-debtor), conditions for contract for necessary utilities (for example, electricity, water, phone) when indebted, and the task would have been enormous.

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8 A broad approach, covering also the material legislation, was utilised in an earlier study to the European Union. See U Reifner et al, 2003.
10 For such an approach, see Reifner et al, 2003.
II. OVERINDEBTEDNESS

In national and international literature, the reasons for and causes of consumer overindebtedness have been the focus of considerable attention. Often the reasons are divided into unexpected, unfavourable live events on the one hand and excessive indebtedness on the other side. No doubt unemployment, disruptions in work history, low income and single parenthood are risk factors that make debtors more likely to become overindebted. In any case, there has to be a fair amount of debt. While we want in no way to undermine the importance of empirical studies that give information on the causes of overindebtedness, in this Chapter our starting point is that in many cases of overindebtedness the abovementioned classification is not sustainable; the debtors have both excessive debt and experience(s) of unfortunate live events.

When the situation turns into ‘overindebtedness’, that is, when the individual or the household cannot cope with the debt load, seems to depend on the economic and other resources of the debtor. Debtors cope differently, some manage surprisingly big debt loads with a happy ending, some just prolong the situation making it worse day by day, and yet others get medical problems and accumulate medical debt on the way. Therefore attempts to define the concept of ‘overindebtedness’ have turned out to be problematic. The indicators may measure well the economic situation or the problems of the debtor but it is very difficult to predict whether the debtor files for a certain discharge process and when the debtor will be subject to enforcement measures from the creditors’ side. Therefore, one of the best definitions of overindebtedness has turned out to be a subjective one: when the debtor or debtor household feels that they are not able cope with their debt burden.

11 For example, Backert et al in ch 13 identify the main reasons for overindebtedness along these lines as unemployment, divorce (unexpected) and loss of financial overview (excessive indebtedness).
12 K Holzscheck et al, Praxis des Konsumentenkredits—eine empirische Untersuchung zur Rechtsoziologie und Ökonomie des Konsumentenkredits (1982); G Hörmann (Hrsg), Verbraucherkredit und Verbraucherinsolvenz (Bremen, 1986); E Kempson, Overindebteness in Britain (London, Department of Trade and Industry, 2002); E Kempson, Credit and Debt the PSI report (London, PSI, 1992).
13 Information on the causes of overindebtedness is important for economic policy analysis as well as legal analysis. While empirical studies on debtors usually produce information on a limited group of debtors only, such as bankruptcy or debt adjustment debtors, they nevertheless tell much about the nature of debt problems. See Backert et al and Oh, chs 13 and 18; T Sullivan, E Warren, and JL Westbrook, As We Forgive Our Debtors (Oxford, Oxford University Press, 1989); T Sullivan, E Warren, and JL Westbrook, The Fragile Middle Class (New Haven, CT, Yale University Press, 1999).
15 This was the conclusion of an earlier EU-study. See B Gianni, N Dourmashkin, MC Rossi, V Verma and Y Yin, Study of the Problem of Consumer Indebtedness: Statistical Aspects
The measures that are taken or directed at overindebted private debtors are not tied with a definition of overindebtedness, with the important exception of opening a consumer insolvency procedure (debt adjustment or consumer bankruptcy). In this Chapter we will discuss measures that are connected with some concrete, identifiable criteria that are associated with the processes of becoming overindebted. The topics that we will take up are registration of credit data and credits, financial education and debt advice, debt enforcement, and the rehabilitation procedures.

III. REGISTRATION OF CREDITS

The use and registration of data about the creditworthiness of individual debtors is a growing industry and has been the object of controversy during the past ten years. The Council of Europe questionnaire produced a rough picture of the market, which is highly centralised with one company dominating the market in many member states. In some states a governmental body or the central bank registers information on debtors and default. Also, there seem to be differences in the regulations of the contents of relevant databases.

Until now the international regulation of credit data has taken place under the data protection, that is, the protection of the privacy of individuals both in national and international law. The Council of Europe Convention on Data Protection (1981), which has later been followed by the European Union directive (1995), has been a path-breaking instrument in laying down the principles of responsible handling of information, including information on creditworthiness. In the preparation of the new consumer credit directive in the European Union, the regulation of credit information was transferred to the context of market regulation and consumer protection. The key concept of the directive proposal was ‘responsible lending’, which tied the consultation of the credit

(Commission of European Union, 2001). Quite an opposite approach is taken by Iain Ramsay in this volume when he examines the different constructions of overindebted debtors in the public discourse. Even though Ramsay’s approach is somewhat ironic, the core of the issue is very serious; overindebtedness is a concept that is loaded with meanings that should be the object of serious research. See ch 4.

16 The legal definition of insolvency (most often ‘the debtor is not able to pay his debts as they fall due’) is often used in the context of consumer insolvency law but it is somewhat misleading since transient inability to pay is not a cause for consumer bankruptcy or debt adjustment. Overindebtedness in the consumer context always refers to overwhelming debt burden or ‘qualified insolvency’ and never simply to a situation in which debts exceed assets. On consumer insolvency as part of general insolvency law, see J Niemi-Kiesiläinen, ‘Consumer Overindebtedness’ in G Howells, I Ramsay and T Wilhelmsson, International Handbook of Consumer Law (Edward Elgar, forthcoming 2009).

17 Niemi-Kiesiläinen and Henrikson, 26.

18 Convention for the Protection of Individuals with regard to Automatic Processing of Personal Data ETS 108 (1981).

19 Directive 95/46/EC on the protection of individuals with regard to the processing of personal data and on the movement of such data.
database to the credit transaction. The proposal to make a central database mandatory for all Union member states and to include consultations with such database in the concept of responsible lending were opposed both by the banking sector and the consumer organisations. These parts of the proposal were taken out of the subsequent, amended proposal and the final directive. In the proposals, however, the two central objects of contemporary controversy over credit registration became apparent.

First, there are different opinions on what kind of information the credit databases may contain. While all countries allow under the data protection law the registration of information on default, that is, so-called negative information, there are very different opinions on the registration of so-called positive information, that is, information on loans that are not in default. The Council of Europe questionnaire tried to obtain information from the member states on the position of legislation on positive information but the question was probably misunderstood by some respondents. It appears that only a minority of countries allow the registration of such information. The answers did not tell about how such information would be collected, used and handled in practice. Even less information exists about the effects of positive information. Secondly, the concept of ‘responsible lending’ used in the proposal for the new consumer credit directive made it clear that the questions related to the duties and responsibilities of the creditors need further consideration before a more comprehensive reform on credit registration is made. If the credit information and consultation of the database is made part of the consumer credit transaction, the quality and reliability of the information, the content of the database (positive or negative information) and the duties of the parties need detailed regulation.

Interestingly, the frontlines in the discussion on the registration of credit information are not clear cut. The consumer organisations are naturally worried about the privacy issues and the reliability of the information but some consumer rights advocates have been interested in the development of the registration of data on non-defaulting credits in the name of prevention of overindebtedness. The banking industry has been worried about the responsibilities of lenders and the costs of a more extensive database. At the moment, the compromise has been reached in giving the consumer debtor a right to be informed of the consultations with a database by the creditor. In addition, the

23 Niemi-Kiesiläinen and Henrikson, 28.
databases should be equally accessible to creditors from all European Union countries. Our inquiry into the legislation of the Council of Europe member states indicates that the regulations in different countries are at very different stages, which does not make the development of the law any easier. The discussions around the consumer credit directive show that there are also a number of issues that need clarification before we can talk about a truly European approach. Even so, there seems to be a common understanding that credit registration issues are important for the prevention of overindebtedness and that the privacy issues need to be taken seriously.

IV. FINANCIAL EDUCATION AND DEBT ADVICE

Financial education and debt advice are easily referred to as the key concept in the prevention of overindebtedness.25 It is often less clear what these concepts really mean.26 We made in our report a distinction between financial education, meaning integration of financial education in the school curriculum and adult education for the general public to improve the financial skills, and debt counselling for persons who already have serious problems with their debts. In many European countries, consumer agencies, social services and non-governmental organisations have developed programmes of debt advice for overindebted consumers.27 There is considerable variation in these programmes in respect of their funding, responsible organisations, focus and orientation. One remarkable difference in their focus seems to follow from the legal context. If the national legislation provides for the possibility of a consumer bankruptcy, the main task of the debt counselling usually is to prepare the debtor for the procedure. In the absence of such legislation, the tasks are often understood more broadly and include, for example, traditional budget advice, payment allocation between different debts, giving information on social services and so on.

In any case, the European consensus seems to be that the financial skills of the citizens need strengthening in the contemporary credit society.28 The challenge, however, is to turn the political consensus into action.

V. ALLEVIATION OF ENFORCEMENT

The efficiency of the justice system and judicial procedures, including debt enforcement, has been the focus of a lot of discussion in the international fora during the last few years. This attention has been largely backed by the argument that an efficient judicial system, including debt enforcement, is a necessary precondition of a functioning credit market facilitating economic growth. The development of the legal framework to promote the growth of the credit market has been considered as a central tool in the transformation of former communist and third world economies into capitalism.29

The Council of Europe has taken a broad view of judicial efficiency and set up a specific structure for monitoring the efficiency of the judicial systems of its member states.30 In this development two themes are relevant for debt enforcement: the efficiency of procedures for small claims and the cross-border enforcement of judgments. The creation of more efficient procedures for small claims has been lately on the agenda of the European Union31 and also the Council of Europe promotes efficient procedures for these kinds of claim. The right to cross-border enforcement of judgments has for a long time been regulated at the European level.32 The enforcement proceedings themselves have so far remained within the jurisdiction of national states. The Council of Europe has, however, paid attention to these proceedings and the Committee of Ministers made a Recommendation on enforcement in 2003.33 While the focus of this recommendation is on the efficiency of the enforcement, it also recognises the necessity to protect the basic needs of the debtor and to strike a proper balance between the creditor’s and debtor’s interests. The Recommendation recognises

29 This is evident in, for example, the World Bank policies: ‘Development and The Bank has long recognized the importance of open and efficient courts to sustained and widely shared economic growth: contracts must be enforced, property rights must be protected, and foreign and domestic investors must have confidence in the legal security of their investments.’ The World Bank, Human Rights and Development: The Role of the World Bank, 15. <http://www.worldbank.org/html/extdr/rights/hrtext.pdf>. See also Joseph Stiglitz, Globalization and its discontents (London, Allen Lane, 2002) 139.


both procedural and material safeguards for the protection of the debtor in enforcement, stating that ‘... certain essential assets and income of the defendant should be protected, such as basic household goods, basic social allowances, monies for essential medical needs and necessary working tools’.  

The member states have indeed followed the recommendation if their legislation has not historically corresponded to it. All member states have laws that protect the personal items and ordinary household objects, tools and educational material of the debtor (beneficium). The standard seems to be what is considered as necessary for normal life. The borderline of what is considered as necessary is at the moment the car, which is not protected in all countries but in some countries it may be kept if necessary for work. The cultural variation among the European countries is obvious. While many Western European countries limit the beneficium to household items and professional tools, in Central and Eastern European countries some agricultural items necessary for own use are included. Even some chattels, such as one cow or a beehive, can be protected.

In contemporary society, most people get their livelihood in the form of wages, salary, pension or other regular income. All countries allow garnishment of wages and pensions, with the exception of Denmark and Greece, which allow garnishment only for public and maintenance debt. Most countries allow one third or one half of the income to be garnished, and for the maintenance debt even up to 70 per cent of the income can be garnished. A handful of wealthy countries allow all income above a certain level to be garnished. A creditor may renew an application for garnishment, which means that overindebted debtors may be subject to garnishment for an unlimited period. Only in Finland, the garnishment is limited to 18 years, not subject to renewal. The survey of the European countries did not allow for evaluation of the protection offered by enforcement laws. Such evaluation would require a comparison of the protection levels with the average consumption levels and basic subsistence levels in each country. A Finnish study from 1996 showed that a schematic garnishment that does not allow for the calculation of the real costs of the debtor households may lead to hardship. In addition, the interviews with the debtors revealed that they had expenses, even payments to creditors who were relatives or who had relatives as personal guarantors that were not accounted for in the calculations of the garnished part of the wages.

There seems to be relatively little discussion on the equity of debt enforcement in the European countries. The regulation seems to have remained the same for a very long time and the regulation of beneficium still reflects thinking from a period when tangible assets represented important economic values.

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34 Recommendation Rec(2003)17 of the Committee of Ministers III 1 h.
35 Niemi-Kiesiläinen and Henrikson, 37.
36 Niemi-Kiesiläinen and Henrikson, 38–9.
37 J Niemi-Kiesiläinen and M Varis, Ulosottovelallisten toimeentulo (The subsistence of the garnishment debtors), National Research Institute of Legal Policy, Research Communications 29/1996.
Now, the most important economic value and source of repayment for ordinary citizens is their regular income, whereas household goods have quite a low resale value. The Council of Europe Recommendation on overindebtedness of 2007 has, for the first time at the international level, paid serious attention to the effects of garnishment on debtors, their families, particularly the children, and pointed out that a balance needs to be made between the basic needs of the debtors and the efficiency of debt recovery.38

VI. REHABILITATION

Individual debtors with overwhelming debt burden were by and large ignored by the European insolvency laws until the late 20th century. An individual debtor could in continental countries file for bankruptcy but he or she would be legally liable for all debts after the bankruptcy. Most bankrupts were companies with limited liability and dissolved after a bankruptcy and almost nothing is known about private persons as bankrupts, except that they were small entrepreneurs in various fields, such as construction and commerce. Only after the deregulation of credit markets in the 1980s and the subsequent economic recession in the beginning of the 1990s, did ordinary citizens start to accrue notable debt loads.

During the 1990s legislators in different European countries discussed the discharge of debt through consumer bankruptcy, or debt adjustment procedures for consumers. In 2005, fourteen European countries, almost one third of the member states of the Council of Europe, had enacted a consumer debt adjustment act. Most of these countries are in the old Western Europe and can be characterised as developed or mature credit societies but also some Eastern European countries have already enacted consumer debt adjustment laws or have plans to do so.39 The first country to introduce such a law was Denmark in 1984. In 1989, France enacted its law for the prevention of overindebtedness. This law allowed regulation and a prolonged payment period of debts but gave relief of debts only under very stringent conditions. This was in contrast to bankruptcy law, which in France is only accessible to debtors who are merchants or engaged in some kind of business but which since 1985 relieves the debtor’s pre-bankruptcy debt. The French law on consumer overindebtedness was changed towards a more relaxed adjustment of debts in 2003 and a bankruptcy for private individuals was added to the law, allowing for discharge of all debt.

38 Rec(2007)8E, 3a–c.
Other Scandinavian countries followed Denmark in the early 1990s and enacted debt adjustment laws. These laws contain a comprehensive insolvency procedure designed for the individual, non-commercial debtor leading to a payment plan and relief from remaining debt. The Scandinavian laws give preference to voluntary settlements between the debtor and the creditors before the case goes to court. In Germany (1994) and Austria (1993) the relief from debt is regulated in bankruptcy law. Even though the debtor is, in principle, required to go bankrupt before the relief procedure, bankruptcy for non-commercial debtors is very simple. The Netherlands (1998), Belgium (1998) and Luxembourg (2000) have enacted laws on collective insolvency procedures for individuals, leading to partial relief from debt. All countries place emphasis on the preventive measures and voluntary agreements between the debtor and the creditors. Estonia (2003) and Portugal (2004) have amended their bankruptcy laws to include a debt adjustment procedure for individuals.

The English bankruptcy law has been changed towards a more debtor-friendly direction during the past decades. The 1986 Insolvency Act introduced an automatic discharge of debts three years after the bankruptcy. After 2002, debtors who have failed through no fault of their own and who co-operate with the bankruptcy administration may be discharged after one year. There is no formal prohibition for consumer debtors using this procedure to obtain a discharge but in practice the high fee for the administration and court procedure (total of £370) is a barrier for some individual debtors. England also has a number of mechanisms which permit repayment over time with the possibility of the debt being written off at the end of the repayment period.

In Ireland, the debtor in bankruptcy is relieved from liability of pre-bankruptcy debt when 12 years have passed after the bankruptcy. This is hardly an option for indebted households, even if they are not legally excluded from bankruptcy.

What is the relationship of these regulations to the objective of prevention of debt problems? The relationship seems to be somewhat complex. An obvious wish of the legislators seems to be that the laws should discourage rather than encourage the use of credit. But since debt adjustment necessarily takes place after the fact, it can only have some specific characteristics that function as disincentives. The parts of the regulation that can, at least in principle, stop or

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40 In Germany a procedure for relief of remaining debts (Restschuldbefreiung) was incorporated in the new Insolvency Act in 1994, which became effective in 1999. Insolvenzordnung (5 October 1994 BGBl 1994, 2866, in force 1 January 1999) 8 Teil §§ 286–30. In Austria, the debt adjustment was introduced in 1993 and became effective in 1995: Konkursordnung-Novelle, 1993.


43 By the Enterprise Act, which came into force 1 April 2004. For more about the law in UK see Ramsay 2003 (England and Wales) and Green, ch 19.

44 Especially the administration orders, Individual Voluntary Arrangements—see discussion in Green, this volume, ch 19.
alleviate the process of becoming overindebted are the emphasis on counselling and the requirement to attempt to negotiate voluntary settlements for the payment of debts.\textsuperscript{45} Certain disincentives to accumulating debt that are built in the regulations are the mandatory payment plan and the control of access to the procedure. Different countries seem to have emphasis on different disincentives, even though all of them have a mandatory payment plan. The payment plan lasts usually five years. After the plan, the debtor is relieved from the outstanding part of the debts. In case of hardship, the debtor may be relieved of the payment obligation completely but may technically be under the plan, which can be amended, if the debtor’s economic situation changes. The other ‘disincentives’ can be used as the basis of classification of the countries into three broad groups.

First, the \textit{Nordic countries} pay a lot of attention to the \textit{good faith test} in their regulation of access to debt adjustment. The courts have the power to deny access to debt adjustment procedure for debtors who have incurred the debts in an irresponsible manner, who have not made enough attempts to pay back the debts or who have incurred big debts right before filing for debt adjustment. In addition, the Nordic countries favour strongly voluntary agreements and require that the debtors try to reach a voluntary settlement with their creditors either before filing debt adjustment, during the initial stage of the procedure or both. Also debt counselling is available and free of charge.

In the second group the \textit{German and Austrian model}, implemented also in Estonia, puts emphasis on the \textit{payment plan}. The debtor earns the discharge by fulfilling the payment obligations of the plan. The plans require that the debtor pays a considerable portion of his or her income to the creditors but the plan may become progressively lighter. The debtor has also an obligation to respect the creditors’ rights by behaving well, that is, working and looking for a job during the plan. The debt adjustment is regulated in the general bankruptcy codes of these countries. In the bankruptcy context, it is natural that access to the procedure is a matter of economic terms (insolvency), not one of moral control of past behaviour.

The third group consists of France, Belgium, the Netherlands and Luxembourg. In these countries debt adjustment is more closely connected with the idea of \textit{prevention of debt problems}, which is apparent even in the names of the laws. The laws strongly \textit{favour voluntary settlements} and give them considerable institutional support. Conditions for a discharge in the judicial procedure are hard and payment plans long. Subsequent amendments of the laws have made discharge more available. Especially the French law is administrative in character and the whole procedure is more bureaucratic than legal in character.

It may be reasonable to ask whether these ‘disincentives’ have the effect that is hoped for. As Jean Braucher argues in this book, such disincentives easily bring with them non-desirable effects, excluding from relief debtors who gen-

\textsuperscript{45} As J Kilborn argues in this volume (ch 15), there is a tendency to simplify the procedures and strike out such pre-court procedures.
VII. CONCLUSION

The aspects of regulation discussed in this Chapter show both consistency and variation over the European jurisdictions. Especially the institutional settings of collecting credit data, of financial advice and of debt adjustment seem to differ, whereas the debt enforcement legislations show some common tradition. The Council of Europe initiative to promote a common approach to overindebtedness may lead to a development of common principles in this field. In this respect, the emphasis on the prevention of debt problems may demonstrate a common European attitude.

The preventive approach to overindebtedness is appealing. Studies of debtors show that overindebtedness causes a lot of suffering, stigma, marginalisation and social exclusion. Even if some debtors are reckless, the great majority would rather pay their debts even with painstaking effort, if it were possible. From the debtors’ point of view there seems to be a plausible reason for a preventive attitude towards overindebtedness. Quite often those who work with debtors support preventive measures.

Prevention of bad debts and losses is of course also in the interests of the creditors. Therefore it is interesting to see how the creditor community reacted to some preventive measures proposed in the first draft for the new consumer credit directive. As Franken shows in this book, both the attempt to regulate the rights of the guarantors along with the regulation of the debtor’s rights and the proposed regulations on the credit data and registers were taken off from the proposal after consultations with the banking sector. The latter proposal would increase the costs to the banking sector, which in the end fall on the consumer. These kinds of considerations always include a trade-off between different costs. The research that has so far focused on the debtors should in the future turn to the other side of the game, the creditors.


\[47\] See ch 7.
The prevention of debt problems has also a great rhetorical power. Society pays the final costs of overindebtedness in the forms of social security payments, lost economic activity and tax payments, health problems etc. But it is impossible to measure the effects of preventive measures, whereas it is easy to count the filings for debt adjustment. The rate of filings and other indicators of overindebtedness are dependent on a number of other circumstances, such as the unemployment rate, changes in the housing market and number of business bankruptcies: these have a much stronger effect than regulation of credit data, financial counselling and voluntary settlements. The problem of overindebtedness has a much wider context than insolvency procedures. The Recommendation that has been the focus of this Chapter has taken important steps to turn attention to the rights of the debtor in the enforcement proceedings and to recognise that overindebtedness most often brings suffering also to third parties. The Recommendation has noted particularly the rights and needs of children in overindebted families and the personal guarantors, often also family members or close relatives of the debtors. These are interests that future research in consumer insolvency should pay attention to.


OVERINDEBTEDNESS HAS BECOME the core element of modern poverty. Where capitalism has taken up the form of a credit society, financial exclusion summons up all the disadvantages which unproductive labour can suffer from in a system where (money) profits decide what we need and what we are allowed to do. Credit unworthiness excludes families from access to the use of all forms of capital, in contrast to traditional forms of poverty, namely unemployment and homelessness, which created exclusion from only certain forms of capital: namely income-generating capital (jobs, physical capital) and homes respectively. As such overindebtedness shares the experience with the other deficits of capitalist societies, all of which have a structural and an individual aspect, an objective fate and an individual fault. People caught in the trap of unemployment may have been lazy, while those without homes may have failed to take precautions. Undeniably, the selections of the credit system, alongside the outcomes of the labour and the housing markets, all depend on factors which can or could have been influenced by the affected individual. However, the general extension of unemployment, homelessness, overindebtedness and poverty does not seem to vary very much with the efforts undertaken by the affected individuals.

In this Chapter I want to explore the chances to affect the objective structural basis of overindebtedness. Through its ideal of perpetual growth, the market favours those who have and punishes those who have not, thereby increasing overindebtedness, and necessitating that we frame market power with a public and social ideal. Unlike the tradition of the welfare state, I do not assume that welfare can only be introduced into markets through centralised state power, as the creation of a centralised authority can sometimes cause more harm than good. Welfare is not synonymous with the state but has a collective dimension.

1 To keep the messages of the following 12 theses short we have referred discussion of them into endnotes. In addition, the oral presentation of these ideas at the Law & Society Conference in 2007 used as an illustration a fairy tale on wolves and sheep which can be downloaded at <http://www.responsible-credit.net/media.php?t=media&id=2619/>. 
This dimension can only be introduced into individual (market) behaviour through the use of rules. Such rules do not have to be simply legal ones, which is why we must look for all kinds of legal, moral, ethical or even just social forms of binding rules. It is indispensable that, whatever the type of rules preferred, the rules should be enforceable. It is important to explore how these rules should be construed in order to create the necessary political pressure to reform a system, which is not individualistic by a choice of the actors but through a compulsory legal form, serving the powerful interests of individuals and firms. Our research is therefore not politically neutral. We explore the conditions under which social justice can be created, facing up to the most visible paradox of modern capitalism, that is, its emphasis on freedom and equality, one which tolerates that children, who can least be blamed for their fate, are brought up in the troubled homes of overindebted families.

1.

Overindebtedness combines an objective element, that is, ‘debt’, with a political value hidden in the word ‘over’. While debt describes the time span between the two sides of an exchange process, ‘over’ depends on a normative assumption which may vary according to the interests of its stakeholders. ‘Overweight’ or ‘Overtime’ have clear standards of reference attached to them, with either ideal weight (health) or a contracted time limit (consent). The ideal amount of consumer debt, however, depends instead on who is concerned and who has the power to define this amount of indebtedness: state, markets, supplier of goods and services, investors, creditors or social welfare. Stemming from this definitional ambiguity, the word shares its vagueness with previous forms of poverty, such as unemployment and homelessness, which European cultures describe quite differently. The statistical significance of these traditional forms of poverty is as disputed as statistics on overindebtedness itself.

Creditors define who will be counted as overindebted. A person is presumed to be insolvent if he or she is unable to pay a mature claim. This occurs when creditors want to enforce money claims that exceed the present liquidity and monthly income of individuals who have no other assets. Overindebtedness is also the visible sign of insufficient prospects for an economically viable future, which could be mobilised via credit. The negative expectations of potential

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creditors manifest themselves in the low score values of these borrowers. This leads to two triangles of defining elements which are either ‘objective’ (1, 3, 6) or a specific ‘label’\(^4\) (2, 4, 5).

From the debtor’s perspective overindebted households lack ‘(1) liquid assets’, ‘(2) creditworthiness’ and ‘(3) perspectives for future income’.

From the creditor’s perspective the loans are: ‘(4) non-performing’, ‘(5) accelerated’, ‘(6) enforceable’.

If only one of these six elements is absent, overindebtedness will not occur. In terms of finding solutions to the problem, any freedom in the choice of intervention is constrained by the fact that measures which directly attack overindebtedness tend to have redistributive effects. This is why regulatory approaches that want to avoid changing the legal system, in which insolvency procedures lead to a significant loss of income, mostly favour the more subjective forms of prevention. They propagate ‘(a) financial literacy’, ‘(b) micro-lending’, ‘(c) responsible lending and borrowing’ (‘reduced access’), ‘(d) debt advice with supervised repayment plans’, or on rare occasions ‘(e) anti-usury laws’. Each of the above-mentioned measures pretends to know the reasons for overindebtedness: unconscious and unskilled behaviour (a), lack of access to adapted loans (b), over-generous offers and too much borrowing (c), unprofessional handling of debt (d), or the exploitation of weakness (e). But these programmes seem to have little effect on the scale of overindebtedness in society.

II.

Overindebtedness is an integral part of the credit society. It mirrors the effect that unequal distribution of labour and other income resources\(^a\) has on individuals and families who, with or without fault,\(^f\) are victims of market discrimination.\(^g\) This market discrimination and the ensuing poverty it creates shows up as a failed consumer credit relation in the credit society. Consumer credit\(^b\) gives access to additional resources calculated on the projection of the future liquidity of the borrowers. Although they in fact borrow the savings of others,\(^i\) its extension, access and repayment are factually and legally organised as if consumers were borrowing their own future income.\(^l\)

Availability of this income, as well as the way the repayment is legally defined, are the two pillars that balance consumer credit relations. To prevent overindebtedness two roads can be taken: debt enforcement practices to adapt the debtor to the repayment needs of the creditors or refinancing, discharge and rescheduling mechanisms to adapt the credit to the factual needs and abilities of the debtor. Consumer protection opts for the latter, which subsequently brings forward the basic questions of the market economy: should the market economy...

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respond to the needs of the people or should people (first) adapt to the needs of the market trusting its invisible hand (Amartya Sen or Milton Freedman)? The basic democratic answer seems to be obvious. If people rule (δῆμος κράτος) they should also rule the economy and the market. But representative democracy, as the only form of democracy that has proved effective, is no suitable means where the welfare of individuals is concerned. Nobody knows what ‘people need’ but only what ‘some people want’. This is why the socialist dream of a planned economic democracy is misleading. But the ‘needs’ remain the goal, while ‘profit orientation’ can only be addressed as a tool to satisfy these human needs. Consumer protection is thus a complementary programme that intends to defend consumer needs rather than merely defending aggregate demand.

III.

Noticeable, however, is that what is commonplace in labour and tenant law is far from being accepted in consumer credit law.\(^5\) The legal concept of justice, according to which the weak should get shelter on an equal basis, is not part of an increasingly neo-liberal definition of consumer protection. Consumer credit law has shifted all responsibility for the asocial outcomes of the credit system to the consumer side. It assumes that markets offer all necessary opportunities to prevent overindebtedness through rational choice. The European Commission applies outdated research on spot contracts (‘Market for Lemons’\(^6\)) to regulate long-term credit relations. According to its programmes and plans, in a competitive European credit market consumers only need three tools to overcome their weakness: education, information and reflection.\(^7\) These three tools will then produce the virtues of an average good consumer\(^8\) who will not only gain strength, but at the same time even create the necessary competitive market. This is of course a circular argument. Competition is not the outcome but the precondition of rational choice. In spite of this misconception, most specialised credit law, and particularly the new EU-Consumer Credit Directive, follows the aforementioned path where the debtor has to adapt himself to the requirements of the market.

This ideology is derived from the common law doctrines of procedural fairness (‘good faith’) where the ‘borrower’ is seen as a market actor who should be

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\(^5\) See endnotes 3 and 5.  
\(^7\) EU Commission, Consumer Policy strategy 2007–2013 COM(2007) 99 final: ‘The response to these challenges lies in equipping the consumer with the skills and tools to fulfil their role in the modern economy; in making markets deliver for them and in ensuring effective protection from the risks and threats they cannot tackle as individuals.’  
offered a fair play. If the rules of fair play are observed, the social outcome of this game is presumed to be fair in itself. According to the doctrine of fairness it may even be fair that a boxer is knocked dead assuming the fight was fair. Instead, the continental European civil law system derives its social attitudes less from fairness than from usury. The usury principle forbids exploitation of weakness, by assuming that an unequal outcome (the boxer’s death) in itself creates the assumption of bad morals or unfairness.9

IV.

In this tradition, the European Coalition for Responsible Credit (ECRC)k demands ‘productive credit’l using the negative legal concepts of fraud, immoral, irresponsible or reckless lending, improvident credit extension and usury. The concept of productive credit makes a choice between fairness and usury. Usurious credit is seen as unfair and procedural fairness is a tool to prevent usury. Wherever consumers have a true and empirically verifiable chance of using productive credit through informed choice, improvement of choice is preferred to legal intervention. The law provides a frame to markets in order to induce them to favour productive credit and punish exploitation in an ‘embedded competition’ (Etzioni).

The struggle for responsible credit targets the supplier side. Development, distribution and the service during the credit relation of credit lie in the hands of lenders. The lenders will respond to the requests for productive credit if such developments are rewarded by the market through additional demand, lower costs or stable long-term relations with their customers, or if they are punished for adverse action.

In theory, lenders are able to profit from responsible behaviour if it would result in less ‘exit’ and ‘voice’ behaviour and in more ‘access’ and ‘trust’ on the consumer side. But obtaining such desired consumer behaviour is less feasible in low income strata, long-term relations, or money business and mass markets dominated by rather few players who design and base their offers on ‘wants’ instead of ‘wishes’. Easy access, low instalments, a lot of money and quickly, as well as hidden prices dominate this market.

But the presumed rational choice of consumers will not necessarily reward the ‘good suppliers’ under perfect market conditions. Rather, the collective effect of negative publicity may damage the general image of a supplier, affect his customer relations generally and especially with the wealthier investment customers, and increase legal, moral or public pressure exerted onto them.n

9 ‘Usury’ (Art 138 par. 2 German Civil Code), ‘Limitation of Economic Power’ (Art 78 no 16 German Constitution); ‘la solidarietà sociale’ (Arts 1 and 119 par. 5 Italian Constitution).
Principles could guide this process if they were formulated in such a way that they would influence the law without being captured by the legal apparatus. Principles share the normative structure and the claim for collective legitimacy with the law but they do not share the legal procedures for their enforcement. Principles are informal like non-legal normative systems, such as religion, ethics and morals. They are close to everyday life, empirically informed and constantly evolving. Unlike political quests they claim objectivity and public interest.

ECRC’s principles of responsible credit claim to facilitate market pressure, orientation and the development of a legal frame for responsible credit. They demand access, information and advice, responsibility and fairness, needs-orientation, effective consumer rights, the prevention of overindebtedness and institutionalised help.

P1: Responsible and affordable credit must be provided for all.

   a. Credit is essential for full participation in society
   b. Banks should not discriminate and should provide real access.
   c. Credit to consumers and small businesses must be supervised.

P2: Credit relations have to be transparent and understandable.

   a. Competitive transparency requires a standardised mathematically cor-
      rect form of ‘one-price’ disclosure (the Annual Percentage Rate of
      Charge or APRC).
   b. Social transparency requires a standardised pre-contractual payment
      plan.
   c. Consumers should be provided with adequate time for reflection and
      with access to independent advice.
   d. Consumers should have access to independent financial, credit and debt
      advice.
   e. Both parties in the credit markets have to take part in a mutually pro-
      ductive process of financial education.

P3: Lending has at all times to be cautious, responsible and fair.

   a. Credit and its servicing must be productive for the borrower.
   b. Responsible lending requires the provision of all necessary information
      and advice to consumers and liability for missing and incorrect informa-

10 For the full text and the reasoning behind it, see U Reifner, ‘European Coalition for
Responsible Credit—Principles of Responsible Credit’ in C Twigg-Flesner, D Parry, G Howells and
A Nordhausen, The Yearbook of Consumer Law (Aldershot, Ashgate, 2008) 419–27; see also
<http://www.responsible-credit.net/media.php?id=1651> (translations into German, English,
French, Portuguese and Spanish).
c. No lender should be allowed to exploit the weakness, need or naivety of borrowers.

d. Early repayment, without penalty, must be possible.

e. The conditions under which consumers can refinance or reschedule their debt should be regulated.

P4: Adaptation should be preferred to credit cancellation and destruction.

a. There is a need for effective protection against unfair credit cancellation.

b. Default charges should be adequate to cover losses only.

P5: Protective legislation has to be effective.

a. Credit regulation has to cover all non-commercial users.

b. Credit regulation has to cover all commercial forms of credit provision.

c. Credit regulation has to cover the whole process of credit extension as experienced by its users.

d. Credit regulation has to encourage efficient social and economic effects of credit extension.

P6: Overindebtedness should be a public concern.

a. Profit-driven systems cannot cope with overindebtedness.

b. Consumers should have a right to discharge.

c. Bankruptcy procedures should lead to rehabilitation and not to retribution.

P7: Borrowers must have adequate means to defend their rights and be free to voice their concerns.

a. There should be adequate individual as well as collective legal procedures to enforce borrowers’ rights.

b. Critical public awareness is crucial for the development of a fair and responsible distribution of credit.

These are not legal principles. These principles are one-sided and an expression of social interest to balance the basic countervailing economic interest of profit maximisation.

VI.

Such principles are not without ambiguity. Principles have a long tradition of abstract ahistorical normative aspirations or assumptions and they, although of a political nature, claim to express moral or ethical values or even sanctity. Their inapplicability renders them less dangerous for those that oppose them, and may allow such opponents to tolerate them. Their claim for legitimacy

11 Principium (Latin) = starting point, basis; princeps (Latin) = leader.
allows collective identification which keeps them alive. Their abstraction separates them from those who created them so that they may even be used against them.

Financial services suppliers increasingly refer to principles in their own marketing. While many of the traditional sets of principles have been used only internally to build corporate identity, the newly emerging sets of principles aim at building more long-term and sustainable customer relations. They respond to an increasing public mistrust towards the financial sector and are mostly defensive strategies. Such supply-side generated principles ‘explain’ profit-driven business as necessary, using a normative and ethical language. The ‘invisible hand’ of the market in financial services is thus made more ‘visible’, with the intention of making the work of the hand more ‘acceptable’. Another group of principles has lately been introduced by legislation in areas such as insider crime, as a response to increased lender liability. Threatened by money claims, such principles try to balance the financial incentives for more profit at any cost through the use of ethical rules. Globalisation and deregulation have cleaned the money system from national culture and they promote the entrance of foreign companies, with very weak ties to the preferences and dispositions of the host country, into the domestic credit markets. Traditional players, such as public savings banks, co-operative banks or national banks, defend themselves reactively by claiming that their models and activities adhere to additional principles of their own, rather than being based on mere profit maximisation.

VII.

Social principles have to be abstract and general just like legal norms. But they do not use this form in order to obey the rule of law and to satisfy their desire to guarantee the balance of state powers. Their abstract and general form claims legitimacy, similarly to former or existing religious, moral or ethical rules. These social principles do not need to disguise the fact that they reflect the normative expectations of special interest groups in society. Similar to the law, such social principles are at least able to claim that following the example they set would be good for the whole of society.

Legal rights have been utilised by social actors to their empowerment. This potential for empowerment can be equally invoked by the principles that express a public interest in a quasi-legal abstract and general manner.

Collective entities which use legal terms outside the formal legal sector in their communication with followers and opponents are rewarded with behavioural certainty, solidarity and group feelings as well as with a feeling of legitimacy. Law is thus community building. However, an obvious problem remains that social interests and especially those of overindebted people rarely have the chance to present their needs in the form of abstract and general rights. To supplement the few legal cases, in which overindebted persons are actually able to
claim paternalistic mercy, which they still have to ‘earn’, social principles will instead provide ‘rights’ outside the law.

But rights are also intimidating. They are burdened with the threat that they may have to be pursued via the legal system. Professional lawyers will overtake, redefine or even reject the needs of the social actors, leaving them to feel misunderstood and underserved and burdened by legal procedures that claim to help them pursue their legal rights. If social movements keep their principles non-legal they will remain in charge of the definition of the problems and the principles. The lack in individual enforcement and effectiveness of these principles will be more than compensated by the increase in identification.

VIII.

A moral purpose-driven form of quasi-legal principles does not have to comply with the rule of law. It can use economic language and be formulated close to the interests of its supporters, thus avoiding that this advantage be turned into a disadvantage where such principles are directly introduced into the law without its legal reformulation. The legal form offers more shelter from political misuse than economic or moral norms which through their purpose-driven formulation hinder the creation of self-certainty, legitimacy and collective behaviour. To profit from these virtues of the legal form social movements have always tried to bring their socio-political programmes closer to the law by developing political principles that at least looked like ‘law in prospect’ as a visible alternative to the ruling law. But contract law is rather immune to social interest. This is especially true for a credit contract that reduces all social aspirations in exchanging money for using money. It hides the fact that consumers mobilise future labour to satisfy actual current needs, which explains why in cases where this income expectation does not occur, the people concerned become overindebted.

Consumers are seen as buyers or borrowers instead of indebted hungry persons and dependent wage workers. They are addressed as debtors and not as overindebted families who have seen their contractual relation cancelled. Likewise, evicted persons are not seen as homeless and garnished debtors are not seen as poor people. Principles of responsible credit would introduce human needs into the flow of capital and social rights into formal contracts. Thus, they would break the immunity of legal formalism, which turns social reality into a purposeless game, for which behavioural finance and game theory, instead of poverty and needs, provide explanations.

To attack the socially discriminatory implications of formal equality and its impoverishing effects, principles of responsible credit have to be formulated

with more concern for the underlying social reality. Freedom of contract, equal
treatment for its parties, and security in its interpretation and enforcement have
to be applied to the factual situation of overindebted families. Those who have
more property enjoy the freedom to exploit and discriminate, because each cent
of an enormous fortune is treated equal to the cent of the poor. The creditors are
guaranteed unlimited security for their claims to the detriment of their debtors
and are awarded a disproportionately high level of state power to garnish, seize
or foreclose on the property rights of the indebted, unemployed or poor con-
sumers.

IX.

The new EU Consumer Credit Directive 2008/48/EC\textsuperscript{13} deleted all socially sig-
nificant precautions included in the 2002 draft, such as the purpose to prevent
overindebtedness and improve consumer protection. Political action at least
stopped this draft from cutting deeply into existing national social consumer
protection through its maximum harmonisation principle, as a number of
exemptions from this maximum harmonisation approach now feature within
the single articles. The final result, after five years of gestation and unsatisfac-
tory handling of stakeholder viewpoints, is that neither the social nor the neo-
liberal approach has been totally adopted.

As mentioned above, the 2002 draft followed the Council’s request to create
responsible credit conditions in order to cope with overindebtedness and
increase consumer protection. By contrast, the 2004 draft successfully intro-
duced by Mr Wuermeling into the European Parliament, in line with all politi-
cal pressure groups from the banking sector, asks for a deregulated European
consumer credit market that should allow suppliers to sell the same products
under the same conditions to people in all countries irrespective of the different
cultures around credit and debt (the ‘McCredit’). Both approaches, however,
still claim to promote ‘good credit’.

For the EU regulator, only the market can define what is good and detect what
consumers need. This view is rejected by the underlying philosophy behind the
ECRC principles. The mere fact that people are overindebted proves that the
credit was ‘bad’ for them. This is not to say that the principles of responsible
credit provide a (paternalistic) answer to the question what good credit would
be. Quite the opposite is true, because there is no answer to the questions how
much credit would be good for customers, for which purposes credit should be
allowed, how much repayment is affordable and what price could be labelled as
‘just’.\textsuperscript{14} When these principles ask for productive and responsible credit, they

\textsuperscript{13} All drafts from 2002 on are available under <http://www.responsible-credit.net/index.php?id=1884>.

\textsuperscript{14} For this approach see Thomas Aquinas, Summa Theologiae, 2-2, q 77, Art 1 based on the bib-
lical phrase ‘do unto others as you would have them do unto you’.
use the dialectics of a double negation: good is *not bad*. The principles rest on a foundation that tries to identify irresponsible credit practices and unproductive credit relations. Commercial practices that try to exclude need orientations from law are thus seen as the target for improvement. Empirical evidence is used to evaluate the true effects of liberalised market practices, and leads to a reconsideration of the lessons learned in labour and tenant law over a century ago.

The principles take into account that the freedom, equality and security of the weak may even be destroyed in the name of these same rights. Freedom for consumers may eventually turn out as the freedom of suppliers to access weak clients with irresponsible lending practices, whereas in the name of equality and security, risk-based pricing may discriminate against the weak and foreclosure and garnishment may create total insecurity for overindebted families.

Giving access to bad credit for vulnerable consumers has not created consumer wealth and opportunity but overindebtedness and insane sub-prime markets. Information overload deters consumers from using any information at all. Time for reflection and senseless information on cost elements has provided predatory lenders with a sense of legitimacy. Freedom to choose has created usurious payment protection insurance with kickback provisions. New complaint bodies for consumers have deferred those who could be opinion leaders into costly and useless individualised procedures. Financial education rebranded as financial capability has created an image of guilt for those who have ‘failed’ and thus reveal themselves as being ‘incapable’. In the form of senseless product information, the rhetoric of financial capability creates a dichotomised consciousness that credit is complicated and that its ordering should be left to the experts.

Such market-failure-fixing principles of responsible credit are designed to promote regulation and not to replace it. These principles challenge the existing right of the legal system to arbitrarily define and explain overindebtedness. They confront such formal standards with social reality and open the door for social empirical research, which alone can question the foundations of the accepted standards. If social research which is free of political and economic influence could return to credit law, if cases could be analysed without prejudice, if measures could be evaluated based on their social ramifications, then the principles of contract law would turn into the most important weapon for social justice.

X.

The discussion introduced through the principles of responsible credit will have to interact with empirical findings on overindebtedness. Seeing that the conclusion of a contract is a legal definition and not an empirical fact, the principles refer to ‘credit’ as an expression of an economic relation and do not refer only to ‘lending’. This reference rejects the assumption that good credit relations are the mere result of a fair treatment at the time when the credit is selected and
granted. The principles look at credit relations in action, and not the promises made at the moment of a loan contract. Usurious high prices, forced detrimental refinancing with early repayment penalties, and exorbitant default fees are all identified as obstacles for the adaptation of long-term contractual relations to the needs of the debtors.

The factors that hinder the development of productive credit relations have to be distinguished from the issue of how such behaviour could be regulated. The law provides instruments that have historically proven to be valuable tools to prevent usurious credit and overindebtedness. Rate ceilings, regulated default interest, protection against forced early termination and acceleration are examples of traditional civil law provisions that, among other goals, prevent overindebtedness. Bankruptcy procedures which lead overindebted families back into the credit system are rehabilitating if they provide organised repayments with advice and help.

To limit misinterpretation and misuse of the ECRC principles, a second layer of sub-principles and relevant commentary to each principle stimulate empirical research and point to concrete applications that challenge some of the legal caricatures associated with debtors.

XI.

In order to remedy the loss of legal formality the external links between law and such principles have to be deepened. The principles address the legal profession and encourage them to develop legal forms that could best suit the political aspirations for social justice. The principles are not alone in their task. We can see here a similarity to international law, where the legal forms and political principles are not sharply separated because they frequently address national legislators and seldom directly the courts. To supervise the effectiveness of international law the European or international courts increasingly apply vague principles directly to cases.

Furthermore, the EU legislator has already opened the doors for such forms of law. Seeking a way to harmonise private law within so many different systems, ranging from the English common law, the Code Napoléon, the BGB to the contract law system of Scandinavia, the EU has opted in its Directives for a non-legal economic form of regulation that favours principles over norms. These Directives are ‘non-binding’ rules which the ECJ has turned into binding rules. They formulate goals instead of describing mechanisms that should be used to achieve them. They start with considerations defining the purpose of the

law, and further still, an explanation to help with an understanding for the underlying problems, something which in civil law would never be allowed. The EU Directives in consumer law especially employ a general clause against ‘circumvention’ which gives the judge the power to apply the law on the sole merits of its purposes even where its wording would not allow it.16

The enormous danger which such developments normally produce for the rule of law is nevertheless tamed by two elements: first, the EU has no own centralised executive power so that the interpretation of the EU law remains largely in the hands of the 27 states; and second, most EU law takes the form of Directives which need transformation into national law. This is why the EU Commission and the Council can write non-legal principles and deliberations as well as empirical assumptions into the considerations introducing the regulation. This structure has the advantage of allowing a direct comparison between the principles on responsible credit and, for example, the Consumer Credit Directive. The principles of responsible credit and the introductory deliberations of the recent Directive are formulated in a similar way.

On the national level the principles can equally serve as a yardstick for legislation. The Greek parliamentary opposition used them to measure government efforts in consumer credit legislation. In Brazil, scientists have used them to develop a body of law for the government. The French semi-public Housing Information Centre (ANIL) used it to formulate requirements for suppliers of mortgage loans. If the principles are further developed into more operational and concrete norms, in such processes that has already been commenced within the ECRC, the principles could directly affect legislative processes.

XII.

Another chance for such principles to become operational lies in the use of general clauses in the law of contracts. The German constitutional court has called good faith, good morals, general customs, notions like acceptability, reasonableness and adequacy an open door for social considerations to enter into contract law and a chance, even an obligation, to make the constitutional welfare principle especially operational in the area of credit and debt.17 Ordre public, bons moeurs, unconscionability and fairness play a corresponding role in other jurisdictions.18 ‘The emperors’ clause’ (Arthur Leff) is present in every contract

16 See for the implementation of such articles into German law by a specific ‘economic interpretation’ in consumer credit law U Reifner, ‘Wirtschaftliche Betrachtungsweise’ und verbundenes Geschäft—ein Beitrag zur Dogmatik der §§506 S.2, 358 BGB’ in WR Bub, R Knieper, R Metz and G Winter (eds), Zivilrecht im Sozialstaat, Festschrift Peter Derleder (Baden-Baden, Nomos, 2005) 489 ff.
17 BVerfGE 89, 214 (19 October 1993).
law of the world. If general principles of responsible credit promoted by more and more social organisations and respected by an increasing number of financial institutions achieve similar reputation as some professional codes or standards (ISA, DIN etc), the court system will be able to use its power to use such principles for creating general standards in the law.\textsuperscript{hh}

Principles of responsible credit can be an arm to combat overindebtedness. They have to be formulated in a purpose-driven socio-economic language that challenges the ideological assumptions underlying formal legal principles on credit and debt. They provoke empirical research and political discussion. In their abstract general and political form, such principles can serve as a yardstick for national legislation and as a basis for the development of consumers’ and debtors’ rights. Their close relation to the law will promote collective behaviour among consumer advocates. EU law is more open to such principles than national law. Faced with cultural differences, it has to recommend instead of ordering, to define ends and to leave the means to others. At the same supranational level, institutions such as the United Nations, ILO, OECD, or Mercosur are similarly open to principles of their own in order to refrain from formalisation. Customs, habits, good faith, good morals and the supranational principle of usury can imply the contents of the Principles to make it more relevant for individual contracts.

EXPLANATORY NOTES

\textsuperscript{a} Anatole France, \textit{Le lys rouge}, 1894 (love between a banker’s wife and a painter) addressed the ‘equal right’ of the rich and the poor to sleep under bridges. Families living in the Favelas of São Paolo or outside Cape Town could be called homeless even when living in a ‘house’.

\textsuperscript{b} In English it is the ‘lack of a paid job’ (‘unemployed’), in German instead we assume that these people ‘do not work’ (‘arbeitslos’), in French it is ‘free of work’ (chômage, chômé), in Italian we assume that such people have ‘nothing to do’ (‘disoccupati’). French trade unions publish their own statistics on unemployment which normally double the number of people who are affected as compared to the official statistics. Home economics claim that a single mother is not ‘unemployed’ but only ‘unpaid’.

\textsuperscript{c} Two EU projects have been dedicated to this question. G Betti, N Dour mashkin, MC Rossi, V Verma and Y Yin, \textit{Study of the Problem of Consumer Indebtedness: Statistical Aspects}, Contract No. B5-1000/00/000197 (London, 2001) made available by iff under <http://www.money-advice.net/media.php?id=90>; Tender No VT/2006/017 on a ‘Common Operational European Definition of Overindebtedness’ attributed to a consortium under the French Observatoire d’Épargne Européenne (Paris), Personal Finance Research Centre (Bristol) and European Consumer Research Institute (Brussels) (its deliberations are outlined in <http://ec.europa.eu/employment_social/social_inclusion/docs/2007/edo_isg_en.pdf>). Preliminary findings were presented at a conference in Brussels on 11 December 2007.

For the discussion on such definitions in Europe see E Kempson and C Poppe, ‘Debt and social exclusion’ in \textit{Proceedings of The European Conference on Money and Debt}

d Social welfare policies provide transfer income (1) or guarantees (2) or rehabilitation (3). Data protection may affect creditworthiness (2), debtors’ protection law hinders acceleration and the increase of the debt burden (5) and bankruptcy laws may render claims unenforceable. (6) In each case this direct intervention has redistributive effects.

e Empirical research has identified lack of income (unemployment, drop in income, low wages) together with the lack of other resources (deriving from all forms of capital: money, pensions, insurance, own labour, houses, land, machinery, family) as objective reasons for default in credit relations. Also problems of ‘additional’ expenditures have been identified like divorce, childbirth, illness, disability (see W Backert, D Brock, G Lechner and K Maischzacht, ‘Bankruptcy in Germany: Filing Rates and the People behind the Numbers’ in this volume; W Backert, *Leben im modernen Schuldturm—Überschuldung von Privathaushalten und soziale Milieus in den alten und neuen Bundesländern—Eine qualitative Fallstudie* (2003) 284 Europäische Hochschulschriften; references to previous international studies in U Reifner, ‘“Thou shalt pay thy debts”: Personal Bankruptcy Law and Inclusive Contract Law’ in J Niemi-Kiesiläinen, I Ramsay and WC Whitford (eds), *Consumer Bankruptcy in Global Perspective* (Oxford, Hart Publishing, 2003) 143 fn 5.

f Fault adds nothing to the definition of overindebtedness as it did not with unemployment, divorce or homelessness. You are overindebted regardless why. But fault (ie Arts 276, 278, 254 German Civil Code) organises the legal as well as the moral distribution of its social burden to debtors, creditors or the state. As modern society defines fault as
the ability to act differently ('wrong choice') the fault discussion is part of the political dispute over who should carry the financial burden of overindebtedness. Empirical studies showing that neither financial education (see LE Willis, 'Against Consumer Financial Education', Paper presented at the Seventh International Conference on Financial Services Regulation, Education, and Cooperation in Responsible Financial Services (Brussels, 2007) <http://www.responsible-credit.net/media.php?f=media&c=file&id=2662>), nor 'responsible lending' (see U Reifner, ‘Responsible Credit in the EU—National Law, the new EU Directive and Beyond’ in EP Delia (ed), 

Competition requires scarce goods, services and resources. Its positive effects on mobility, flexibility and productivity in the economy are therefore consistent with at least temporary exclusion in labour (unemployment), housing (homelessness) and credit (overindebtedness) markets. Exclusion is the only most significant form of price differentiation.

Credit is historically a form of using other people’s assets for a certain time before compensating for it. Children start with the credit from their parents before they, as adults, start to pay into a pension plan, which in fact will pay back this credit to the elderly. Any form of ‘do ut des’ assumes at least some seconds of credit. Money credit (‘loans’ or ‘deferred payments’) is a fairly recent phenomenon. The law dealt historically only with unpaid callable claims (Codex Hammurabi). Consented loans as a means to use centralised capital in the partition of labour had therefore no roots in the law of credit but in rent law (renting a slave, labour law and leases). If we talk about consumer credit today we mean ‘renting’ capital so that one can use one’s future income for present expenditures.

Credit is a transfer from those who have to those who have not. You can only borrow and use existing and never future capital. But ideologically it is a form of reversed savings (post-savings distinct from pre-savings) which organises the process of credit extension. In former times access to credit was defined by the amount of existing savings of others carefully controlled by the central bank’s money policies ('psychological rule', JM Keynes, _The General Theory of Employment_ (first published Cambridge, Macmillan, 1936), Interest, Chapter 8 III: ‘These reasons will lead, as a rule, to a greater proportion of income being saved as real income increases.’) Monetary theory instead assumes that credit opportunities create money so that future expectations can provide actual income (for more see U Reifner, ‘Zur Zukunft des europäischen Verbraucherrechts—Soziale Dauerschuldenverhältnisse in der Kreditgesellschaft’ (2007) 22 _Verbraucher und Recht_, Special Issue '20 Jahre iff', 31, 12 ff; partly in English in U Reifner, ‘Renting a Slave—European Contract Law in the Credit Society’ in T Wilhelmsson et al (eds), _Private Law and the Cultures of Europe_ (The Netherlands, Kluwer Law International, 2007) 325 ff.

All credit is modelled according to an assumed future flow of income: instalment loan where labour income is assumed, balloon payment where one-time profits, like indemnities after military service, are assumed or a revolving credit relation where short-term liquidity is provided as payday loans, credit card loans or overdraft. The amount of credit extended is tailored according to the assumed disposable income (which some states fix at 30% of the monthly income). Assessment of creditworthiness (esp. scoring) relates primarily to running income and fixed expenditures.
Securities are income-related (wage attachment, personal guarantee). Bankruptcy schemes prolong the income relation through the assignment of wages like in the German system or Chapter 13 of the US bankruptcy code.

ECRC was founded in 2006 by a number of social organisations in Europe as a loose coalition of stakeholders in banking and finance. It comprises consumer organisations, money advice, anti-poverty and anti-usury groups as well as alternative finance and microfinance institutions. It organises national conferences as well as an annual international meeting, furthers an informed and high-level dialogue with the supplier side and collaborates with the American NCRC on international questions of Community Reinvestment and responsible financial services. See <www.responsible-credit.net> as well as the related <www.GlobalFairfinance.net>. There are also corresponding sites in German, French and Italian/Spanish/Portuguese.

Credit can be called productive if its return for the borrower is higher than its cost. With productive credit the borrower’s aspirations come true as he or she will be able to invest future income for present purposes so that it furthers actual consumption at an affordable price which is appropriate in relation to the expected gains and at conditions that allow its repayment with existing liquidity. In short, a credit is productive if it neither leads to impoverishment nor to overindebtedness. Thus, the use of consumer information and consumer education truly can achieve tangible gains. Learning from behavioural economics, consumer information is seen in connection with consumer advice. In financial education both sides are parts of a system of mutual learning in which besides information also the competence and power to act can be generated. Consumer rights as well as blaming and shaming are necessary because the individual consumer has to educate the supplier side to adapt to his or her needs and social risks. Instead of ideological training in market faith, consumers have to learn how to influence product policies.

See Bolton and Dewatripont, *Contract Theory* (2005) 488: ‘Rather than optimizing over a general contract set that is subject to incentive, renegotiation-proofness, and participation constraints, long-term contracts are taken to be of a pre-specified (incomplete) form, and the control variables become instead ownership titles, control rights, decision-making rules, discretion, tasks, authority, and the like, to be allocated among contracting parties.’

It is interesting to note that in Italian law overindebtedness is identified with usury in the ‘law on the Solidarity fund’. This law intends to fight usurious credit practices by supporting debt advice organisations financially (Art 6 Law 23 February 1999 no 44 on the Solidarity Funds for the Victims of extortionate credit and usury; 1- Legge 23 febbraio 1999 n 44—Disposizioni concernenti il fondo di solidarietà per le vittime delle richieste estorsive e dell’usura).

A theoretical discussion of those approaches that have dealt with the role of principles in the context, shadow or form of law would certainly be of high theoretical interest. But this will probably not be of help for this quite pragmatic approach to develop principles that can be used in social action for a specific social purpose. The word ‘principles’ is used in a very descriptive way and not linked to a theoretical concept. It describes a set of normative aspirations guiding a social movement. The answer to the question which form and contents it should have will be given by its potential to ‘change the world’ and not by its potential for ‘interpreting it’ more properly. In so far it is used as a label it certainly aims at the law but remains outside the discussion of the role of principles in the law. According to this, law can be based on principles
Kelsen, HLA Hart), can respond to a hierarchy of topics (Viehweg), reflect basic views and ideologies (Karl Marx), mirror social developments and power relations (Max Weber) or reformulate habits (Eugen Ehrlich). It may also be just ‘the right answer’ (Ronald Dworkin) in each single conflict or all of them. But our principles do not have to deal with the complexity of legal rules that govern the whole of society instead of particular interests. As each society develops its own rule and mechanism to structure its social cohesion it will depend largely on its size, affluence and scarcity, ethnical homogeneity, form of production, even climate and temper whether they use and forward principles in the law. The principles we are talking about in this context do not claim to structure the whole of society.

The biblical Ten Commandments, the French Human Rights charter, the American declaration of independence, the Communist Manifesto profit from such aspirations which environmental charters like the Exxon Valdez Principles and many other similar declarations claim too.

While in the pre-capitalist world the then religiously justified principles are all formulated in the imperative form of orders (‘shall’), the bourgeois society has introduced a new rational (‘raison’) form of principles which pretend to describe instead of ordering: ‘Humans are free and equal’ and not ‘all people should be free and equal’. This typical form of defining human rights is also used in the socialist movement: ‘Workers break their chains’ instead of ‘should’.

George Orwell describes this shift of principles in his book Animal Farm. Robespierre’s terror after the French Revolution or Stalin’s terror after the Russian Revolution as well as the application of biblical principles in so many religious wars and even the modern wars waged in the name of human rights show such ambiguity of abstract principles in social movements which need a political or economic power for its definition ex cathedra. In the ‘Manifesto of the Communist Party’ (1846) Karl Marx states: ‘The weapons with which the bourgeoisie felled feudalism to the ground are now turned against the bourgeoisie itself.’

The French Cetelem has published four principles on responsible credit, GE Money has set up 30 principles of responsible lending, the British Bankers’ Association has published principles of responsible lending to which all members adhere, the German Teambank propagates responsible credit rules. The Luxembourg Bankers’ Association has set up a code of conduct in which they promise that they will act with ‘loyalty, equity and integrity . . . without discrimination . . . shall seek information on the situation of their customers . . . keep their customers clearly and loyally informed and give . . . appropriate and correct information’ <http://www.abbl.lu/download/20695/1/abblcodedeoen.pdf> (for more examples see our rubric ‘responsible credit/principles’ on the ECRC websites.

A number of much-publicised scandals, such as currency speculation against developing countries, sale of junk bonds or junk real estate to the broad public, overpriced credit life insurance with usuriously high kickback provisions, ‘risk-adjusted’ hidden pricing, secured credit cards, sale of subprime loans to funds, breakdown of pension funds and the activity of hedge funds, have undermined the reputation of banks and made customers more sensible and after an era of deregulation politicians more open to new interventions.

The seven ‘London Principles of Sustainable Finance’ originated by the ‘London Corporation’ claim environmental (P3–P5) and social responsibility (P6–P7) on the basis of a dedication to economic development in general (P1–P2). In spite of many
words they only reveal that what banks do is responsible, social and sustainable as such. Principle 1 claims wrongly: ‘Allocating finance from savers to companies and individuals investing and innovating is the primary wealth creation role of the financial services sector. Trading in financial assets is an essential part of this role, to the extent that it enables market prices to be established and to exert market control for the efficient running of the underlying companies and projects.’

v The World Savings Banks Institute (WSBI) has ordered research on Corporate Social Responsibility of their members. The report is based on the following assumption: ‘For savings banks across the world, contribution to society remains the core of their socially responsible involvement. However, these commitments to society activities traditionally developed by savings banks stand as one of the pillars of a broader CSR approach. The main purpose of this report is to illustrate the diversity and wide range of CSR policies and projects launched by savings banks around the world’ <http://www.wsbi.org/>. In America all major banks use the Community Reinvestment Obligations to demonstrate their ‘Community Involvement’ (see, eg, Bank of America: ‘More than 450,000 hours are devoted to local causes each year. Social responsibility, diversity and volunteerism improve a community’s quality of life. Recycling initiatives reduce the environmental impact of our business. The bottom line is this: Team Bank of America makes us a better company.’ Ken Lewis, Bank of America CEO <http://www.bankofamerica.com/teambank/>.

w Social entities which interact on a regular basis develop express or underlying principles. Trade unions, rank and file, associations or just members of a local community define their internal communication differently from the general communication of their members.

x In the early 1980s much research was done on ‘access to justice’ (see M Cappelletti (ed), Access to Justice and the Welfare State (Nijmegen, 1981); E Blankenburg and U Reifner, ‘Conditions of Legal and Political Culture Limiting the Transferability of Access To Law Innovations’ in M Cappelletti (1981); E Blankenburg and U Reifner, Rechtsberatung Rechtsprobleme durch soziale Definition (Darmstadt/Neuwied, Luchterhand, 1981); U Reifner, ‘Zugangs und Erfolgsbarrieren in der Justiz’ (1981) Demokratie und Recht 143, 396 ff, which in fact due to a basic problem in English language mostly confounded ‘justice’ with ‘courts’. Our own research (see Blankenburg/Reifner 1980; Reifner 1981) used a broader concept of ‘justice’ (‘Gerechtigkeit’ instead of ‘Recht’) which incorporated a critical dimension into law which, according to the history of social movements, was always seen in its dualism of own rights and exclusion through the right of the stronger party. Methodologically based on Levin’s approach of ‘action research’ we worked with interest groups like tenants’ initiatives (U Reifner, ‘Types of Legal Needs and Modes of Legalization. The Example of the Berlin Tenants’ Initiative’ in E Blankenburg (ed), Innovations in the Legal Services (1980), investigated the historical development of the use of legal forms within trade unions (U Reifner, Gewerkschaftlicher Rechtsgebrauch—Die Geschichte des gewerkschaftlichen Rechtsschutzes und der Rechtsberatung der Deutschen Arbeitsfront von 1894 bis 1945 (Science Centre Berlin, 1979) IIM discussion paper 79, 103) and consumer organisations (U Reifner, Neue Formen der Verbraucherrechtsberatung (Frankfurt, New York, Campus Verlag, 1988).

Our findings revealed that substantive and procedural law create opposing forms of social action. If social activists formulate ‘rights’ rooted in substantive law collective action becomes more feasible. If they turn to the judiciary (including mediation and
individualistic action can be expected. Legal procedures are thus a funnel for social consciousness—collective rights are transformed into individualistic claims.

In a highly successful action research project on usurious credit (U Reifner/G Volkmer, Neue Formen der Verbraucherberatung Campus, Frankfurt/Main, 1988) we could demonstrate that by reformulating consumer interests into legal principles and legal norms for out-of-court action we could significantly increase the willingness of consumers to defend their rights and we could even change jurisprudence that had until then rendered the legal interdiction of usury inefficient. Interviews and observations showed that overindebted consumers derived behavioural self-esteem as well as a more collective and political view of their problems together with elements of solidarity if their interests were presented in the form of (alternative) legal rights.

Banks are repeat players and consumers are one-shotters (see M Galanter, ‘Why the “Haves” Come Out Ahead: Speculations on the Limits of Legal Change’ (1974) 9 Law & Society Review 95; MH Kritzer and S Silbey (eds), In Litigation do the ‘Haves’ still come out ahead? (Stanford, CA, Stanford University Press, 2003). Repeat players profit from collective advantages when risks are spread and standardisation lowers costs. In bank law where the main cost lies in the assessment of the facts, professionals can be hired. Scientists who get high expectations for future earnings from repeat players will be more willing to follow the interest of this party. A recently bankrupt German investment shark (‘Göttinger Gruppe’) when threatened by closure a few years ago revealed the names of 13 of the most renowned professors in bank law who had testified in their expertise that their system was legal and sane. They then escaped closure. In 2007 when it was finally closed €2 billion had been lost and it is now acknowledged that the system was in fact insane and also illegal—too late for those 100,000 small investors who entrusted their pensions to this group (see on the scandal how investors had been treated by the German court system the TV programme Monitor, 21 June 2007 <http://www.wdr.de/tv/monitor/beitragsuebersicht.phtml?sid=165>). If consumers fail, they will lose 100% without risk spread. They are unable to carry the cost burden, lack professional experience and are unable to offer financial rewards to the bar through additional cases. This may now change in Germany where consumer lawyers have formed networks and are allowed to advertise and where publicly financed consumer organisations (‘Consumer Centrals’) have got the right to claim for consumers.

Germany, whose legal profession is so proud of its scientific and rational form of law, is also the most outstanding example of how the legal form can be destroyed through the introduction of purpose-driven factual elements into the law via legal interpretation. Already in the 1920s the courts turned to a purpose-driven application of the law (see Reichsgericht 1924 RGZ Vol 107 p 78 ff; B Rüther, Die unbegrenzte Auslegung—Zum Wandel der Privatrechtsordnung im Nationalsozialismus (Tuebingen, Mohr Siebeck, 2005) 74 ff; U Reifner, Institutionen des faschistischen Rechtssystems, Das Recht des Unrechtsstaates—Arbeitsrecht und Staatsrechtswissenschaften im Nationalsozialismus (Campus, 1981) 11. Where the courts found that the ‘purpose of the law’ was not met by its literal application they managed to introduce their antidemocratic views and use jurisprudence as a political weapon to defeat liberal democratic developments. The Nazi government could misuse this shift from formal to purpose-driven interpretation of the law by declaring that their party programme was the general purpose of all laws. In 1936 they amended Art 2 of the Criminal Code (28 June 1936). To the old definition that punishment could be what was described in
the law it was added ‘that should equally be punished which according to the basic idea of the law and according to the “gesundes Volksempfinden” (“sane people’s feeling”) merits to be punished’ (RGBl I p 839).

Instead of purpose-driven economic language where, for example, a consumer credit contract is a ‘contract’ (formal) where somebody who buys with the purpose of facilitating consumption (economic) and gets money with the purpose of using it as a purchasing power (economic) legal language only accepts empirically verifiable formal actions like the transfer of money in a loan contract.

In the late 19th century the labour movement used the word ‘Volksrecht’ (people’s law) as an alternative to bourgeois or official law (see U Reifner, ‘Individualistic and Collective Legalization—Two Ways of Legal Advice for Workers in Prefascist Germany’ in Abel (ed), The Politics of Informal Justice (New York, Academic Press, 1980) 81 ff; ibid, Gewerkschaftlicher Rechtsgebrauch—Die Geschichte des gewerkschaftlichen Rechtsschutzes und der Rechtsberatung der Deutschen Arbeitsfront von 1894 bis 1945 (Wissenschaftszentrum Berlin, 1979) IIM dp 79 103; Boaventura de Sousa Santos published a thorough analysis on the normative settings in Pasargada, a favela of Rio de Janeiro where its inhabitants made a distinction between (their) ‘Pasagarda law’ and the (state) ‘law of the asphalt’ (B de Sousa Santos, ‘Law of the oppressed: the construction and reproduction of legality in Pasagarda’ (1977) 12 Law and Society Review). In the fight against colonialism alternative law is situated between law and politics and typically constructs a common identity for those who fought together. (For more research by de Sousa Santos on this topic see: Capitalism and the rule of law (London, Hutchinson, 1979); ‘Law and revolution in Portugal: the experiences of popular justice after the 25th April 1974’ in R Abel, Politics of Informal Justice vol 2 (New York, Academic Press, 1979); Law, state and urban struggles in Recife Brazil (Law School Working Paper, University of Wisconsin-Madison, 1979). ‘On modes of production of law and social power’ (1985) 13 International Journal of the Sociology of Law.) Anarchism in Spain confronted the bourgeois legal order with their principles of anarchism which was in fact not the abolition but the transformation of the legal order. Bourgeois law itself developed via principles of trade and freedom during the middle ages within an existing feudal legal order. Opposition parties and movements turned their aspirations into principles which prepared a new legal order which went hand in hand with the increase in power.

Contract law is based on ideological assumptions which, if internalised by the players on the market, provide effective low-cost economic communication. Contract ideology was thus able to replace a whole regulatory body which amounted to more than 19,000 articles alone in the Prussian General Law (ALR) of 1794. This helped to overcome feudal privileges and restrictions as well as unnecessary obstacles to free trade. But its radical formalisation also excluded all elements of social culture and justice also in its modern forms. Axiomatic assumptions like ‘money you have to have’ applied to overindebted families now hinder the legal system to develop solutions to the present debt crisis. This crisis is no longer a problem of overindebted consumers but of money markets in general. Market deregulation has allowed predatory lending that created extremely high returns. Its risks have been shifted to others through securitisation. The high yield of these securities has attracted other investors who bought the risks without sufficient information to upgrade their weak return on own capital. This again provided incentives to increase high interest and high-risk credit where the profit remained with its generator while the risks were carried by others. Now as the
incurred risks become obvious the state in Germany and the UK use taxpayers' money to bail these institutions out (Northern Rock, LBS Saxony, WestLB, Citibank, Bear Sterns, Berliner Bankgesellschaft).

We experience an alarming retreat of independent social research from debt-related questions. After David Caplovitz’s ingenious research on poverty (The poor pay more: consumer practices of low-income families (New York, Free Press, 1963); Consumers in trouble: A study of debtors in default (New York, Free Press, 1974); The merchants of Harlem: a study of small business in a Black community (Beverly Hills, Sage Publications, 1973); Making ends meet. How families cope with inflation and recession (Beverly Hills, Sage Publications, 1979)) got all further requests for research grants denied during the Reagan administration, which replaced such research by bank-sponsored projects at Purdue University, Janet Ford (Consuming credit: debt and poverty in the UK (London, CPAG, 1991); Banking for People (Berlin, De Gruyter, 1992); The indebted society: credit and default in the 1980s (London, Routledge, 1988) as well as Richard Berthoud, Credit and debt: the PSI report (London, 1992) were not mandated to continue their independent research. Instead the Bristol-based PFRC has obtained a quasi-monopoly in the UK whose research questions are formulated by industry and government. At EU level ECRI in Brussels and OEE in Paris, both bank-sponsored research groups, have obtained the above-mentioned contracts on overindebtedness which in its research questions already assumes that insolvency, overindebtedness and exclusion are all the same. In Germany the two big private entities who collect the data on defaulting consumers, SCHUFA and Creditreform, both now issue an annual report on ‘overindebtedness’ where they misinterpret their data and pretend to be able to explain overindebtedness by age and postal address (see SCHUFA Schuldenkompass (Wiesbaden, 2007, 2006, 2005, 2004; <www.schufa.de>); Creditreform, Schuldneratlas Deutschland 2007, Neuss 2007 <www.creditreform.de>.

Art 249 European Treaty: ‘A directive shall be binding, as to the result to be achieved, upon each Member State to which it is addressed, but shall leave to the national authorities the choice of form and methods.’ This wording of the Treaty has since been turned into its opposite. In reality EU Directives are replacing national law especially through maximum harmonisation. More and more executive power is shifted to the EU. The European Court has rendered EU Directives directly applicable within national law for public entities if the transformation is late or insufficient or inadequate (EuGH Rs 152/84 Slg 1986, 723f: ‘Marshall’). Although this does not apply to private parties in contractual relations (EuGH Rs C-91/92 Slg 1994, I-3325 ‘Paola Faccini Dori / Recreb’) it affects them through interpretation. A number of member states, due to a lack of expertise, have implemented Directives in their original form so that apart from the traditional formal body of law these countries (Italy and Greece with regard to the Consumer Credit Directive) have now a second body of economic and purpose-driven consumer law which bears enormous threats for the formal security of their legal systems. With its 2002 reform Germany, which first overtook the economic approach in its ‘Consumer Credit Act 1991’, has opted back by separating consumer credit into loans, instalment purchase contracts and other financing instruments. Anyhow the more power will be allocated in Brussels with the new EU basic contract the more EU law must either be transformed from economic purpose-driven language to traditional politically safe legal forms or banned from immediate effects on the national level.
For example the Commission held in its considerations on the CCD 2002 that national
consumer law was hindering trans-border shopping of consumers in consumer credit
in order to support their maximum harmonisation approach. The German presidency, aware that this argument was empirically ill-founded because there were nei-
ther offers nor demand on cross-border consumer credit as nearly all major European
banks already chose to be present in the other states, just inserted the word ‘some-
times’ in its 2007 draft. This in fact was a polite form of telling the Commission that
its arguments were purely ideological. The considerations of the CCD contain
assumptions and ideological neo-liberal arguments on consumer choice, competition,
reasons for default, practice in leasing or cross-selling of insurance that cannot be
verified. This approach provides on the other hand an incentive to confront these
deliberations with our principles of responsible credit. At least both sides play on the
same level field.

Within ECRC the information principle P2 and its counterpart in the new CCD have
been discussed. With their paper ‘When is a Right of Withdrawal not a Right of
Withdrawal?’ the ECRC concludes: ‘If nations choose to take approaches that achieve
the purpose of the Directive—in this case by introducing a “cooling off” mechanism
that will work in practice—then this would conform with the Directive itself. To sum-
marize, we suggest that an important change is required to make the right of with-
drawal in the new Consumer Credit Directive an effective means of enhancing both
consumer protection and economic efficiency. That change is to create a default
option in typical credit contracts that would require a waiting period of ten days
before the money is actually transferred to the borrower. The new waiting period
could be shortened if the consumer makes an explicit decision to override the default.
Without such a change, the right of withdrawal proposed by the council is unlikely to
become a practical option for consumers.’

In my research on ‘Inclusive Contract Law—Poverty in Common and Civil Law’ (down-
I have analysed the relation between ‘collective law’ (including collective agreements,
international treaties, soft law, principles etc) and individual contracts. The sixth and
seventh thesis of my summary reads as follows:

‘6th The adjustment of individual contracts through general norms and values is
not new. In the name of efficiency and commercial security the individual will and
consent has been interpreted in the light of customs, habits or the rational observer.
Quasi-contracts, implied contracts, contracts out of socially typical behaviour
(“sozialtypisches Verhalten”), the clausula rebus sic stantibus, factual contracts or
culpa in contrahendo are additional legal constructions, which all create “contracts”
where society wants to imply them. Contracts of adhesion are treated as unilateral
contracts reviewed in the light of good faith. Good morals, good faith, uncon-
scionability, usury and other general clauses empower the judge to interfere with con-
tact terms. These methods all refer to a value system behind the contract, to guide the
decision of the judge and the jury. I call this contract behind the contract “social con-
tract”.

‘7th Individual contracts are erected on implied social contracts of social consensus.
The contractarian approach in contract theory, which refers to “the social contract”
in the sense of Hobbes, Hume, Rousseau, Kant and Hegel, is only the most general
form of social contracts defined in the human rights part of the constitutions. But the
“social contract” based on individual freedoms falls short of social aspirations. The
second layer of these human rights, the right of access to the substance (home, property, family, education etc) for which freedom is guaranteed so that freedom can also be enjoyed has only got some general mentioning in the constitutions like the social welfare state principle in Art 20 of the German Constitution. Concrete social contracts have to be much more outspoken on these social rights because the apparent wording of individual contracts is heavily influenced by the power relations between creditors and debtors in society. The law and economics approach builds on this view of efficient behaviour. Profit-driven economic activity is accompanied by non-monetary production (ie empathy), money transfer in non-market production (ie welfare in household production), not-for-profit market production (ie state-sponsored production). Such a national economy is ruled by another standard of efficiency which is more than just saving money and making profit. Law has to embrace all economies of society. Legal economics therefore have to decide first which part of the social economy is concerned. If contract law distributes tamed state power for private use, contract law must incorporate also these areas of social economy which the principles of responsible credit want to make more visible.”
I. INTRODUCTION

The history of consumer credit regulation is as old as consumer credit itself. The first civilisations known in history had already endeavoured to find a balance between facilitating economically useful credit extensions and protecting vulnerable borrowers against abuse by lenders. Throughout history, strategies employed have included the forgiving of debt, interest rate caps, outright bans on usury, and charitable and co-operative lending.¹ A more recent innovation is the use of disclosure regulation to protect consumer borrowers. Disclosure regulation does not intervene in the credit agreement. Instead, by providing consumers with full information on the cost of credit, it aims at enabling consumers to choose the credit product that best fits their means and needs. As a corollary, consumers would be enticed to shop around to find the best credit offer, thereby pressuring lenders to offer credit at lower prices.

While disclosure regulation comes with the promise of combining the fostering of a vibrant consumer credit market with a high level of consumer protection, such a promise will only be met if full disclosure is the norm. However, if the drafting of disclosure rules is captured by interests benefiting from a lack of transparency in the costs of credit, disclosure regulation will not fulfil its function of fostering competitive consumer credit markets and providing a high level of consumer protection. This was exactly what happened after the introduction of the Truth in Lending Act in the United States in 1968. The drafting of disclosure rules by Congress was captured by financial industry lobbyists who

transformed it into a complex set of rules allowing many fees to be excluded from the finance charge.\(^2\) As a consequence, nowadays the finance charge is a far cry from an easy-to-understand, all-inclusive price tag.

The EC Consumer Credit Directive\(^3\) (CCD) has chosen the method of disclosure of the annual percentage rate of charge as a means to further both the adequate functioning of the internal market for consumer credit and the protection of consumer borrowers. The CCD has just been revised.\(^4\) This Chapter tries to shed some light on the political forces that have shaped the final text of the revised CCD. Specifically, it aims to determine to what extent the positions taken by consumer and financial industry groups have had an impact on the final text. Apart from consumer and financial industry groups, important actors in the drafting of a revised CCD are the Commission, the European Parliament, and the national governments represented in the Council. The EC institutions, and in particular the Commission as agenda setter, seek to expand their competencies in the field of consumer protection. This has resulted in a move away from minimum to maximum harmonisation directives. In so doing, the Commission tries to pre-empt national consumer policies.\(^5\) The same shift from minimum to maximum harmonisation can now be observed with respect to the CCD.

To pre-empt national regulation that protects consumer borrowers, the Commission has to frame its proposals in terms of integration of the internal market.\(^6\) The Commission does so by stating that the disparate legal responses of the Member States with respect to the protection of consumer borrowers has resulted in a distortion of competition between creditors in the internal market and a restricted scope for consumers to obtain credit in other Member States. Fostering cross-border credit extension and greenfield entry by credit providers requires enhanced consumer confidence and the prevention of trade obstacles resulting from disparate legal responses. The Commission seeks enhanced consumer confidence by increasing the level of consumer protection offered by the CCD, while it hopes to mitigate the obstacles to trade owing to diverging laws by introducing a maximum harmonisation approach. The possibility to offer credit contracts throughout the EU should result in improved efficiencies and economies of scale for banks, and cheaper and wider selection of products for consumers.\(^7\)

The move from minimum to maximum harmonisation, inspired by the Commission’s pro-integrationist agenda, is one of the most contested developments in EC consumer law. It is often argued that market integration in the

\(^2\) *Ibid*, at 899–902.


\(^6\) Art 153 EC Treaty.

European Union will lead to a lower level of consumer protection, with market integration mainly catering to the interests of industry. Industry would be more effective in influencing EC policymakers than consumers because of its better capability to organise at the EC level and the high per capita stakes of its members in the outcome of the EC legislative process. The difficulty that consumers face in effectively organising themselves at the EC level would result in industry’s capture of EC policymaking. If industry considers national standards of consumer protection as too strict, it could try to overhaul such standards by pushing EC institutions to introduce maximum harmonisation at a lower level of consumer protection than that of the highest-standard Member States. In addition, by pushing for maximum harmonisation, industry could try to halt the development of higher standards at the national level.

However, the representation of consumer and industry interests at the EC level may not be that black-and-white. The EC governance structure offers interest groups multiple access points to EC policymaking in the form of a national and European route. First, in following the European route, interest groups can lobby the Commission, the parliamentary committees, individual members of the European Parliament and the Council Presidency. Second—and more promising to diffuse interests such as consumers’—interest groups can follow the national route by pressuring their governments to champion EC-level policies in the Council of Ministers. This route does not require a transnational organisation of interests and benefits from direct responsibility of national officials to their electorates. Consumers in high-standard Member States can push their governments to advocate high standards in the Council of Ministers. Yet the presence of both high-standard and low-standard Member States reduces the chances that the Council of Ministers will reach consensus on high standards.

The main question addressed in this chapter is to what extent the financial industry’s capture of the legislative process has occurred, in that the financial industry has been able to dilute the proposed provisions for an amended CCD. This Chapter is organised as follows. Part II briefly discusses the main characteristics of the EC retail banking market and some problems in the market for consumer credit. Part III outlines the draft proposals for a revised CCD. Part IV summarises the main positions of the financial industry and consumer groups on the proposals for a revised CCD, and assesses the extent to which their participation in the policymaking process may have had an impact on the final outcome. A considerable part of the financial industry’s positions is reflected in the consecutive drafts for a revised CCD, while this is not the case with respect to the positions taken by consumer groups. Part V continues by analysing the

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reasons financial industry might actually have to resist stricter disclosure rules, and the extent it might be in favour of application of mutual recognition or the country of origin principle to consumer credit regulation, the application of which could result in a deregulation of consumer credit in the EC. Finally, Part VI provides a brief conclusion.

II. THE RETAIL BANKING MARKET AND CONSUMER CREDIT IN THE EU

In the framework of two sector inquiries, the Directorate-General for Competition of the European Commission has outlined the main characteristics of the European retail banking market. At the supply side, market concentration differs considerably across Member States. In all Member States, the major players are full-service providers. The number of non-domestic banks among the leading banks is limited, and few players have a leading market share in two or more Member States. Cross-border extension of retail products is almost non-existent. In addition, greenfield entry hardly occurs, especially where it concerns full-service banking. Entry into national retail banking markets mainly takes place through mergers and acquisitions. Major barriers to entry are formed by divergences in the information content of credit registers across Member States as well as limited access to credit registers, the importance of local branch networks, low customer mobility and the divergence of consumer protection rules.

The demand side of the EU retail banking market is characterised by low customer mobility owing to high switching costs for consumers. High switching costs can be caused by a lack of price transparency, high search costs, administrative burdens associated with changing service providers, bundling and tying of financial products, and high closing charges. Product tying—the sale of two or more products together of which at least one product is not sold separately—is a common strategy for retail banks throughout the EU. Product tying may weaken competition by (1) raising consumers’ switching costs, (2) discouraging potential rivals from entering the market, especially stand-alone providers of the tied product, and (3) reducing transparency and comparability among providers.

The lack of price transparency, high search costs, bundling and tying of financial products, and high closing charges (for instance, in the form of high pre-payment charges) all are phenomena present in the EU consumer credit markets.

12 Ibid at 19–20.
13 Ibid at 15.
14 Ibid at 49.
Consumers are still confronted with a lack of transparency in the costs of credit. To date, in many European countries the costs of voluntary payment protection insurance, early repayment charges, overdraft charges and default rates need not be disclosed to consumers. Disclosure of these costs often only occurs in the credit agreement itself, so that consumers are not aware of such costs prior to signing the contract. This has led to a situation in which lenders can hide the true costs of credit by shifting costs from interest rates to, or by charging disproportionately high rates for, cost elements they need not disclose to consumers. Needless to say, the problem with hiding the true costs of credit is that the pricing of credit escapes the competitive process.

Lenders can exploit the lack of transparency in the costs of credit for the purpose of product tying. A salient example of a tie-in is offered by payment protection insurance, which is offered in combination with consumer loans and insures the consumer against the risk that he cannot pay his credit instalments due to death, sickness, accident, incapacity to work, or unemployment. Lenders often offer consumers the possibility to take out such insurance alongside the credit without indicating how much more the loan will cost than the advertised rate. In this way, consumers are unconsciously tricked into buying the insurance. Moreover, upon signing the contract, consumers receive one price quote for what is actually a bundle of a loan and an insurance product. This makes it hard for consumers to compare the prices of the individual components of the package. In sum, consumers are de facto forced to buy payment protection insurance without having any information on either the price or the other characteristics of the product. The costs of payment protection insurance can, however, amount to 30 per cent or more of the total cost of credit to the consumer.

There are three main problems associated with this practice. First, as lenders do not have to disclose the price of payment protection insurance before the signing of the contract, they can compete by lowering the interest rates on their loans, while at the same time keeping the cost of credit the same by charging the consumer for payment protection insurance at non-competitive rates. This creates the false impression among consumers that they are buying lower-priced credit. Second, the consumer might end up buying a product that he would not have bought had he known its terms upfront. Third, as the costs of payment

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17 Ibid at 7. On the website of the UK personal loan store consumers are pointed to the fact that payment protection insurance ‘can cost the consumer almost as much as the cost of the interest, nearly doubling the cost of the loan’, see <http://www.ukpersonalloanstore.co.uk/articles/payment_protection-insurance.html> accessed 23 May 2007.
protection insurance are not disclosed to consumers, the lender can raise the cost of the premiums above the actual credit risk the consumer exposes the lender to.\textsuperscript{18} If the latter occurs, a loan against a somewhat higher interest rate covering the increased risk, but without payment protection insurance, might have been a better deal for the consumer.\textsuperscript{19}

III. BRIEF OVERVIEW OF THE PROPOSALS FOR AMENDMENT OF THE CCD

In 2002 the Commission came up with a proposal to amend the CCD.\textsuperscript{20} The then existing CCD was a minimum harmonisation directive, which provided few rules and left many issues unregulated. It excluded several cost elements from the annual percentage rate of charge, among which charges for credit insurance voluntarily taken out by the consumer. It also excluded from its scope many credit agreements, notably mortgage credit and loans smaller than €200 or larger than €20,000. Most Member States had drawn on the minimum clause to go beyond the provisions of the CCD by extending the scope of their consumer credit legislation to cover more credit agreements and creditors, and by including more detailed rules on credit advertising and contractual information. In addition, Member States had taken many initiatives with respect to issues not provided for in the CCD, such as the introduction of a cooling-off period, usury laws, rules on damages to be paid by the consumer in the event of default, and rules to protect guarantors.\textsuperscript{21}

The Commission’s proposal improved the informational quality of the annual percentage rate of charge by defining the total cost of credit as all costs that the consumer has to pay for the credit. It considerably extended the scope of the CCD by including equity release mortgages and surety agreements. It expanded the list of information to be provided in advertisements, at the pre-contractual stage, and in the credit agreement. It subjected overdraft facilities and small loans to the same information regime as other credit agreements. It proposed a ban on door-to-door selling of credit and surety agreements. It introduced a duty to advise, imposing an obligation on creditors to establish the most appropriate type of credit for a consumer given the consumer’s financial condition and ability to repay. The Commission also introduced the concept of responsible lending, which requires a creditor, prior to concluding a credit agreement, to assess whether the consumer can reasonably be expected to repay its obligations under the agreement. Furthermore, the Commission added a

\textsuperscript{18} See Reifner, above n 16, at 76.


\textsuperscript{20} COM(2002) 443 final.

\textsuperscript{21} COM(95) 117.
The Commission also proposed the right of creditors on a ‘fair and objective’ indemnity in case of early repayment. Finally, the Commission introduced the maximum harmonisation approach, meaning that Member States are not allowed to maintain or adopt more far-reaching provisions in their national laws where the CCD does not offer them such leeway.

However, the Commission’s initial proposal was watered down considerably. The first watering down resulted from amendments made by the European Parliament. In its 2004 proposal the Commission took over many of the European Parliament’s amendments. It excluded equity release loans and surety agreements from the scope of the CCD, subjected overdraft facilities and credit cards to a light information regime, deleted the ban on door-to-door selling, narrowed down the definition of the total cost of credit, reduced the concept of responsible lending to a requirement for the creditor to assess the consumer’s creditworthiness on the basis of accurate information provided by the consumer, and, where appropriate, on the basis of a consultation of the relevant database. The Commission did not adopt the amendment of the European Parliament to reintroduce the minimum clause. After renewed consultations with stakeholders the Commission came up with a third proposal in 2005, in which it kept the maximum harmonisation approach in place and added a mutual recognition clause with respect to the provisions on responsible lending, pre-contractual information, the duty to advise consumers, the right of withdrawal, early repayment, overrunning of the total amount of credit, and the obligations of credit intermediaries.

Second, the Council limited the cost elements to be included in the total cost of credit to those that are known to, or should reasonably be found out by, the creditor. Moreover, it left out credit insurance where the consumer is not obliged to take out such insurance upon concluding the credit agreement. In addition, it excluded all home loans from the scope of the CCD and exempted loans smaller than €200 and larger than €100,000. The Council introduced a Standard European Consumer Credit Information form, by means of which the pre-contractual information has to be provided to the consumer. In case of early repayment of fixed interest rate credits where the reference rate is lower at the time of early repayment than at the conclusion of the credit agreement, the Council’s compromise text granted creditors a limited right to compensation (0.5 per cent or 1 per cent of the amount of credit repaid early). Moreover, it granted Member States the right to provide that the creditor can claim compensation only if the amount repaid within 12 months exceeds a threshold defined by the Member State, which threshold shall not exceed €10,000 within any period of 12 months. Furthermore, the Council watered down the duty to advise

to an obligation to explain the essential characteristics of the product. Finally, it deleted the mutual recognition clause.

The European Parliament and the Council pre-negotiated a political informal agreement prior to the vote of the European Parliament. On 16 January 2008, the European Parliament voted in favour of this pre-negotiated text. On 7 April 2008 the Council approved the changes made by Parliament. The final text of the revised CCD exempts credits larger than €75,000 from the scope of the CCD. It also retains the Council’s compromise text on compensation of the creditor in case of early repayment.

IV. REPRESENTATION OF CONSUMER AND FINANCIAL INDUSTRY INTERESTS

This section outlines the positions of the financial industry and consumer groups on the proposals for an amended CCD. In addition, it tries to find out to what extent the interests of the financial industry and consumers were represented during the CCD drafting process. It takes as its starting point the public positions of industry and consumer groups regarding the scope of the CCD, the disclosure rules, the duty to advise, responsible lending, the right of withdrawal, the right of early repayment, maximum harmonisation and mutual recognition. As a measure of possible success of lobbying efforts, this part considers to what extent changes made to the Commission’s initial proposal coincide with positions taken by financial industry or consumer interest groups.

A. Financial Industry Groups

Several financial industry groups are active at the EC Level. Their position on the CCD can be summarised as follows. As regards the scope of the CCD, the financial industry finds that overdraft facilities and small loans should be excluded from its scope, as including these facilities would make them expensive and unprofitable to lenders, which in turn would force lenders to stop

28 The materials cited in this section can all be found on the respective websites of the organisations referenced.
29 The positions of the following European financial industry groups were examined: the European Banking Federation (EBF), the European Financial Services Roundtable (EFR), the European Association of Co-operative Banks (EACB), European Savings Bank Group (ESBG), the European Federation of Building Societies, and the European Banking Industry Committee (EBIC). EBIC represents EBF, ESBG, EACB, European Mortgage Foundation (EMF), EFBS, Eurofinas Leaseurope, and the European Association of Public Banks (EAPB).
extending these types of loans and thereby reducing consumers’ access to credit. In addition, the financial industry holds the opinion that all housing loans—including mortgage loans, equity release loans and unsecured housing loans—should be excluded. Being different, long-term products, mortgage loans would not fit into a legal framework specifically designed to address consumer credit products. Instead, industry prefers self-regulation of housing loans in the form of the European Code of Conduct on Mortgage Credit. With respect to the cost elements to be included in the total cost of credit, the financial industry finds that only the costs attributable to the lender should be taken into account and that insurance costs should be excluded unless extension of the credit or the advertised rate is made compulsory upon taking out such insurance. On the issue of information provision to consumers, industry generally feels that only a limited amount of information should be provided at the advertising stage.

With respect to the issue of responsible lending and the duty to advise the customer, the financial industry fears that the risk of lender liability for faulty or inadequate advice or creditworthiness assessments will make the process of credit extension more expensive, which, in turn, will result in a reduction of high-risk customers’ access to credit. Moreover, it rejects a duty of the lender to advise the consumer, as the credit provider would only be in a position to explain the features and characteristics of the product offered.

The financial industry generally favours a fully harmonised right of withdrawal based on a period of seven days combined with the possibility of the consumer to waive such a right should he wish to ask for immediate delivery of the goods or services financed. Moreover, creditors should be allowed to make credit available before the end of the withdrawal period. As regards early repayment, the financial industry is of the opinion that lenders should be fully compensated for the losses incurred as a result of early repayment. Banks would

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no longer offer fixed interest rates for long-term credit products, such as fixed rate mortgages, if consumers had a right to early repayment at any time during the contract.36

With respect to the issue of maximum harmonisation and mutual recognition, the European Banking Federation (EBF) and the European Banking Industry Committee (EBIC) favour targeted maximum harmonisation of ‘key provisions’ of consumer credit regulation, such as the right of withdrawal, the right of early repayment, the duty to advise, responsible lending, pre-contractual information, overrunning the total amount of credit, and the obligations of credit intermediaries.37 But harmonisation should not be at the highest possible level.38 After the publication of a revised proposal in 2004, the Commission held consultations with Member States and stakeholders. Among others, the Commission met several times with EBIC, with national banking associations, and with a number of major banks.39 As the Commission indicated in its explanatory memorandum to its 2005 proposal, a number of the comments obtained in the discussions with these financial industry representatives were taken into account in the text of the Commission’s 2005 proposal.40 The 2005 proposal excluded all mortgages, including equity release mortgages, from the scope of the CCD. This coincides with an amendment of the European Parliament strongly supported by the financial industry. Moreover, the Commission followed a recommendation solely made by the industry representatives of the Forum Group on Mortgage Credit, whose recommendation was not supported by the consumer representatives.41

Other amendments made by the Commission in line with comments of industry include the limitation of cost elements included in the total cost of credit to costs known to the creditor, the exclusion from the total cost of credit of the costs of payment protection insurance voluntarily taken out by the consumer, the submission of overdrafts and small credits to a light information regime, the exclusion of credit agreements above €50,000, the deletion of a few pre-contractual information requirements, the deletion of the obligation of Member States to set up centralised databases as well as the duty of creditors to consult databases,42 and the addition of the right of creditors to charge fair and objective fees to compensate for their losses in case of early repayment by the debtor.

37 EBIC, above n 34, at 3 under 8; EACB, Letter to Finnish Permanent Representation to the EU, 27 July 2006.
38 Letter of EBIC to Gordon Baker (clerk to sub-committee G on social and consumer affairs of the House of Lords) of 12 April 2006; EFR, above n 30, at 6.
39 Letter of Robert Madelin, Director-General of DG SANCO (European Commission) to Gordon Baker, Clerk to the European Union Sub-Committee G of the House of Lords (UK), 2006 (no exact date indicated) (the letter does not mention the names of associations and major banks).
42 Other provisions that were deleted from the 2005 proposal in line with financial industry’s comments include information requirements with respect to guarantors, a ban on unsolicited doorstep selling, a provision denoting several terms in a credit agreement to be unfair, and a provision on the joint and several liability of the supplier of goods or services and the creditor where the supplier has acted as credit intermediary.
After the Commission had issued its 2005 proposal, the financial industry continued its lobbying efforts, as evidenced on the EBIC website. On 17 February 2006, EBIC, EBF, the European Savings Bank Group (ESBG), the European Association of Co-operative Banks (EACB), the European Mortgage Federation, the European Federation of Building Societies, the European Association of Public Banks (EAPB), and Eurofinas/Leaseurope met with representatives of the Directorate General for Health and Consumer Affairs (DG SANCO) and the Directorate General Internal Market and Services (DG MARKT). On 6 July 2006, the same group met with the then Finnish Presidency of the Council. During these meetings, EBIC repeated its positions. These lobbying efforts yielded mixed results for the financial industry. In its common position, the Council did indeed exclude all housing loans from the scope of the CCD and limited the duty to explain to the essential characteristics of the credit product. But it set the lower threshold for application of the CCD at €200 and the upper threshold at €100,000 and granted creditors a limited right on compensation in case of early repayment. Although the recommendation of the Committee on the Internal Market and Consumer Protection of the European Parliament again amended these latter provisions in line with the position taken by the financial industry, the final compromise text upholds the Council’s position on early repayment though lowering the €100,000 limit to €75,000. Yet the argument of the financial industry that extensive disclosure rules would make the extension of small credits and overdraft facilities too expensive must have struck a chord with the Committee, which stated in a press release that ‘too many bureaucratic requirements might discourage banks from offering credit on favourable terms’.

B. Consumer Organisations

At the moment, there is only one European consumer organisation that represents the interests of consumer borrowers at the EC Level, namely the European Consumer’s Organisation (BEUC). Apart from BEUC, various types of national consumer organisations participate in the policymaking on consumer credit both at the national and European level. First, there are the members of BEUC, which are the large national consumer organisations active on a wide range of consumer issues and financed by their consumer members. A second group of consumer organisations consists of often public or semi-public institutions that have as their objective to advise (often for free) and assist people in debt. Third, there are groups that campaign against extortionate lending and promote

43 See Draft Minutes of the meeting of EBIC CCD Working Group held on 17 February 2006 at Hotel Amigo, rue de l’Amigo 1–3, 1000 Brussels.
44 See Draft minutes of the meeting of the EBIC CCD Working Group held on 6 July 2006 at the seat of the ESBG, rue Marie-Thérèse 11–13, 1000 Brussels.
responsible lending practices. These can be ad hoc organised groups or more permanent organisations such as the UK ‘Debt on our Doorstep’. Finally, there is the European Coalition of Responsible Credit (ECRC).\textsuperscript{46} To promote a discussion on the issue of responsible lending among consumer groups on the one hand, and governmental bodies and suppliers of credit on the other hand, the ECRC organises national and European conferences on such issues. The organisations that support the ECRC are groups that all belong to the aforementioned three types of consumer organisations mainly active at the national level. Although ECRC does not officially present itself as an organisation presenting the interests of consumers, the views it has expressed on the proposals for an amended CCD mainly coincide with the views expressed by consumer organisations.

The position of BEUC on the proposals for an amended CCD can be summarised as follows. It considers the maximum harmonisation approach as one of the biggest drawbacks of the proposal. It points out that maximum harmonisation comes with the danger that no action is taken until sufficiently wide consensus has been established across the EU. Moreover, it fears that it will reduce the level of protection currently available in at least some Member States. According to BEUC, the Commission should combine the protection instruments used by Member States, retaining for each issue the instrument likely to offer the best protection.\textsuperscript{47} In addition, BEUC is against application of a principle of mutual recognition to issues that are not dealt with by the CCD. It points out that mutual recognition might lead to an unravelling of consumer protection rules in the medium to long term, and adds to the confusion of consumers.\textsuperscript{48}

With respect to the scope of the CCD, BEUC opposes the exclusion of housing loans. Also, it is of the opinion that, if a mortgage credit directive is not adopted, the annual percentage rate of charge of the CCD should also apply to mortgage credit.\textsuperscript{49}

In many respects, BEUC favours information and advice requirements that go beyond those of the 2002 proposal of the Commission. According to BEUC, advice on consumer credit by lenders should follow the principle of ‘best advice possible’ and for certain risky or complicated contracts the CCD should implement additional information requirements.\textsuperscript{50} Furthermore, it opposes application of a light information regime to overdrafts, credit cards, and small loans.

BEUC favours interventions in interest rates. Interest rates are not regulated by the CCD, but are subject to regulation in several Member States. First, to facilitate the comparability of credit offers BEUC is in favour of strict limits on

\textsuperscript{49} BEUC, above n 47, at 4–5.
\textsuperscript{50} BEUC, above n 47, at 6.
the variability of interest rates. Second, BEUC generally favours interest rate ceilings. While it acknowledges the difficulties involved in fixing one usurious rate for the entire EU, it suggests that interest rate ceilings differentiated according to loan size and term should be considered.51

BEUC supported the concept of responsible lending as it was included in the 2002 proposal, namely making credit institutions responsible for evaluating the capacity of a consumer to repay a loan. It feels that the creditor is best placed to assess the consumer’s ability to repay and to evaluate the default risk.

The position of BEUC on the right of withdrawal is that it should be without a penalty, without an obligation to justify the withdrawal, and disbursements during the withdrawal period should be prohibited unless expressly requested by the consumer.52 According to BEUC, the provisions on early repayment do not go far enough. BEUC refers to the negative impact of high closing and early repayment fees on customer mobility. It sees merits in a statutory ceiling on such fees to stimulate customer mobility and competition accordingly.

Although in 2002 BEUC cautiously welcomed the initial proposal of the Commission, the watering down of the proposal that followed has led to a growing gap between the proposed text for a revised CCD and BEUC’s views on consumer credit regulation. Only two amendments made to the initial Commission proposal more or less coincide with the views of many consumer organisations. First, the final text maximally harmonises only a few provisions of the CCD. Second, the final text caps early repayment fees.

It seems as if consumer organisations have had less of a foothold than the financial industry in the policymaking process at the EC level. BEUC took part in the 2001 consultation of the Commission on the review of the CCD and made its position on the 2002 and 2005 proposals publicly available through its website. BEUC also took part in the CCD hearing of the Legal Affairs Committee of the European Parliament held on 29 April 2003. During the hearing BEUC was the only consumer organisation invited to speak, whereas 10 European industry associations, four national banking federations, two individual banks, and a number of industry-funded groups were invited.53

V. ANALYSIS OF THE POLITICAL DETERMINANTS OF THE CCD

It seems as if most amendments made to the Commission’s initial 2002 proposal cater to the interests of the financial industry. Part A of this section explores the reasons the financial industry might have to resist stricter disclosure rules. Since the financial industry has not made its reasons explicit, a hypothesis will be formulated thereon. In addition, part A also points out some limitations of an
approach to consumer credit regulation that solely focuses on information disclosure. Part B analyses the interests the financial industry might potentially have in the federalisation of consumer credit regulation. The financial industry has not overtly expressed its views on this issue, so that again a few hypotheses thereon will be formulated.

A. Information, Customer Mobility and Vested Industry Interests

Key arguments made by the financial industry to resist full disclosure of the price of credit often fall short of persuasiveness. Pointing out that home loans are ‘different’ and ‘long-term’ products does not explain why borrowers of mortgage credit could do with less information on the price and other conditions of a credit product than the borrower of a personal loan. With respect to the need to exclude from the total cost of credit payment protection insurance voluntarily taken out by the consumer, the financial industry does not even explicitly state a reason why consumers should not be properly informed on the costs thereof. This begs the question of what the financial industry’s real reasons might be to resist stricter disclosure regulation.

The major players in the European retail market are full-service providers with substantial shares in their home markets. A compelling reason for these incumbents to resist stricter disclosure regulation and intervention in high closing fees, such as early repayment charges, might be their interest in maintaining their current business models, which rely on cross-selling, bundling, product tying, cross-subsidisation, and consumer lock-in due to high closing charges. When the annual percentage rate of charge is not a reliable source of information, consumers will rely on other characteristics of the creditor. Consumers may, for instance, decide to borrow from well-known credit providers with a reputable name. In essence, they then choose a well-vested brand. The lender’s proximity may also influence the consumer’s choice of credit provider. Once consumers have chosen a credit provider, they are likely to be locked in the relationship with this credit provider. In sum, incumbent credit providers benefit from a lack of transparency and high closing fees.

In general, credit providers benefit from limited information provision in the early stages of the sales process. Once prospective customers have passed the first stages of the sales process, they are less likely to engage in comparison shopping. Moreover, upon reaching the stage of contract signing, consumers may feel morally committed to sign the contract. This effect may be even stronger if they sign their credit contract at the premises of the credit provider. These consumer behavioural traits shed a different light on the potential costs that a right of withdrawal may impose on credit providers. These costs may be low, if not

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54 See above n 14–17 and accompanying text.
absent. After all, if consumers are not inclined to shop around in later stages of the sales process, they will be even less inclined to do so once they have signed the credit contract.

Yet even if full disclosure of the total cost of credit at the advertising stage were the norm, consumers may still not engage in comparative shopping due to high search costs. Both the Cruickshank Report of 2002 on banking services in the United Kingdom\textsuperscript{56} and the more recent inquiry of the Commission into the European retail banking market\textsuperscript{57} have shown that customer mobility is low. The Cruickshank report found low degrees of shopping around by consumers before buying a mortgage, personal loan, current account or savings account, even though there was a considerable spread of prices of these products on the market and consumers thus could have obtained these products at lower prices had they shopped around.\textsuperscript{58} A recent survey held among 1,265 Dutch consumers who had bought or had considered buying a personal loan during the past five years, reported that more than half of the interviewed indicated that they had not compared the credit taken out with credit offers of other credit providers. Of the consumers who said they had compared credit offers, 40 per cent indicated that they had experienced difficulties in making a sound comparison.\textsuperscript{59} Such inertia of consumers may simply be laziness, but it may also originate from the fact that buying a personal or mortgage loan is not the same as buying a dishwasher. While most consumers understand the functionalities of a dishwasher, they find it more difficult to understand the characteristics of a credit product and to determine which of the credit products on offer best fits their means and needs. Even if each credit offer provided full information on the cost of credit, a consumer may find himself taken aback by the difficult task of deciphering and comparing offers. Consequently, a substantial number of consumers may simply refrain from comparing offers and rely on the credit provider’s reputation or proximity instead. If so, even in these Internet times price dispersion may continue to exist, incumbent banks may not necessarily lose customers to competitors that offer lower-priced products, and customers may prefer local banks over foreign banks that extend credit cross-border.

Apart from high search costs, consumers’ cognitive biases may also reduce the chances of effective competitive pressure. For instance, consumers may believe that certain risks that can seriously affect their ability to repay a loan, such as unemployment, will not happen to them thereby underestimating the probability that they will default on the loan.\textsuperscript{60} As a result, consumers may not focus on default rates when entering into a credit contract. This may also lead them to incur more debt than an unbiased consumer would incur. With regard

\textsuperscript{56} Ibid.
\textsuperscript{57} See above n 10–11.
\textsuperscript{58} See above n 55, at 108, 115, 119.
\textsuperscript{59} EIM, Overkreditering aan banden: onderzoek naar de effectiviteit van beleid om overkreditering tegen te gaan, Zoetermeer: September 2007 (research report delivered to the Dutch Ministry of Finance), at 8.
\textsuperscript{60} Eg National Consumer Council, Credit—Choice or Chance?, 2002, at 4–5.
to overdraft facilities such as credit cards, consumers often underestimate their use of the credit facilities. Consequently, when buying a credit card, consumers tend not to focus on the interest rates charged on keeping a balance. These and other cognitive biases call into question whether the provision of full information to consumers suffices to create a competitive consumer credit market. In addition, they cast doubt on the usefulness of the average consumer as a yardstick for the setting of standards of consumer protection. The European Court of Justice has formulated the average consumer as somebody who ‘is reasonably well-informed and reasonably observant and circumspect’ and the Unfair Commercial Practices Directive adopted this concept of the average consumer. This average consumer seems to be based on the rational actor model of economic theory, which predicts that consumers make optimal consumptive choices when provided with full information. However, if a considerable part of consumers suffers from various forms of cognitive biases, this prediction may not hold.

What consumer inertia and cognitive biases make clear is that enticing consumers to shop around requires more than full information disclosure. Consumers may need independent third parties to help them comparison shop. An impartial third party could rank credit providers not only on the basis of the annual percentage rate of charge, but also on overdraft, default, penalty and early repayment charges. Providing comprehensive comparative information on the latter charges may lower the barrier for consumers to actually take these costs into account when deciding on which credit product to buy. This could contribute to overcoming some of the consumers’ cognitive biases that may otherwise prevent them from making informed choices. Moreover, an impartial third party could point out which characteristics of a credit product consumers should take into account when deciding which loan to avail. Of course, to enable a third party to fulfil its role of information provider in a satisfactory way, full information disclosure at the advertising stage should be the norm. Unfortunately, the amended CCD does not prescribe full disclosure at the advertising stage.

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64 See, eg, above n 55, at 138–40 (suggesting that the FSA could fulfil the role of providing comparative information to consumers).
B. Mutual Recognition, the Country of Origin Principle, Maximum Harmonisation, and the Race to the Bottom

The Commission’s objective to foster cross-border credit extensions and greenfield entry by credit providers has informed its choice of maximum harmonisation. To avoid market protectionism, the Commission proposed application of the principle of mutual recognition to a few provisions of the CCD that, despite maximum harmonisation, still left Member States some leeway in implementation. However, to stimulate cross-border credit extensions, the Commission could have recommended more radical approaches. It could have suggested application of the principle of mutual recognition to all provisions of the CCD that fall short of maximum harmonisation or, more radically, application of the principle of mutual recognition to all national consumer credit laws and regulations including those that are not covered by the CCD. Still more radical would have been application of the country of origin principle to both the issues regulated by the CCD and those falling outside the scope of the CCD.

Mutual recognition and the country of origin principle set aside Art 5 of the EC Convention on the Law Applicable to Contractual Obligations, which provides that a credit contract is governed by the law of the country in which the consumer has his habitual residence and that a choice of law does not set aside the mandatory rules of the law of such a country. The difference between mutual recognition and the country of origin principle is that the first principle cannot find application against mandatory legal requirements or public policy of the host country, provided these requirements serve an objectively justifiable goal. Consumer protection and fairness of commercial transactions can constitute such objectively justifiable goals. The country of origin principle, on the other hand, sidesteps such mandatory requirements or public policy restrictions. Thus, of the two principles, the country of origin principle best serves the goal of stimulating cross-border credit extensions. Assuming that credit providers perceive the costs of compliance with different national consumer credit laws as well as the costs of high standards of consumer protection as substantial, both mutual recognition and the country of origin principle could entice credit providers to relocate to low-standard jurisdictions or force national governments to relax their standards of consumer credit regulation. Consequently, a race to the bottom could ensue. Needless to say, the race to the bottom is likely to be most severe in case of application of mutual recognition or the country of origin principle to all consumer credit laws and regulations.

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When usury laws and rules of responsible lending are subjected to either the mutual recognition or the country of origin principle, credit providers may have an even stronger incentive to relocate to low-standard jurisdictions as doing so may considerably increase their profit margins. A parallel can be drawn with the deregulation of interest rates that ensued from the 1978 Marquette decision of the United States Supreme Court, which essentially introduced the principle of home country control with respect to credit card interest rates. As a consequence, credit card issuers relocated to low-standard states and high-standard states started to abolish their interest rate controls.

Consumer organisations are opposed to the application of maximum harmonisation, mutual recognition or the country of origin principle to consumer credit regulation. In contrast, the financial industry generally supports the maximum harmonisation approach, but has largely been silent on the principle of mutual recognition and the country of origin principle. If all members of the financial industry wanted to foster cross-border credit extensions, one would have expected them to call on the Commission, the European Parliament and the Council to introduce the country of origin principle to all national laws and regulations affecting consumer credit. Such a call has as yet not been made by EBF, EBIC and the like. This raises the question of whether credit providers might have different views on application of these principles, specifically where it concerns the application of these principles to all consumer credit regulations. Alternatively, it raises the question of whether (some) credit providers may be in favour of application of these principles, but have reasons for not openly expressing their views.

The extent to which credit providers are in favour of application of mutual recognition or the country of origin principle to all consumer credit regulations may depend on (i) the investments they have already made to build up or acquire a branch network in different Member States and/or, (ii) whether the Member State in which they are located is a low-standard or a high-standard jurisdiction. Credit providers that have built up their own branch networks in more than one Member State or that have acquired branch networks in other Member States may be opposed to the principle of mutual recognition or the country of origin principle, as they may fear cross-border competition from credit providers that did not invest in branch networks. In addition, incumbent credit providers in high-standard jurisdictions may fear cross-border competition from credit providers located in low-standard jurisdictions. The resistance to mutual recognition or the country of origin principle may be even stronger where it concerns banks—such as savings banks in Germany—that are legally restricted to conduct their business within a certain geographical area. Specifically, these banks cannot benefit from mutual recognition or the country of origin principle, as they cannot relocate their business to low-standard jurisdictions. Thus, application of mutual recognition or the country of origin principle confers benefits

on those credit providers that are located in low-standard jurisdictions and do not invest in branch networks in other Member States.

Even so, high switching costs could impede customers from choosing foreign credit providers. As a result, large incumbent banks may have little to fear from application of mutual recognition or the country of origin principle in the short to mid term. In the short to mid term, incumbents are likely to benefit from their reputation and proximity to their customers. Strangely enough, they could even be in favour of a country of origin principle. Not with a view to facilitating cross-border credit extension, but with a view to lowering the standards of consumer protection. The risk of competition from foreign credit providers located in low-standard jurisdictions could be a powerful tool in the hands of incumbent credit providers located in high-standard jurisdictions to lobby their national governments to relax consumer protection standards. If the country of origin principle applied to all consumer credit laws and regulations, a successful lobby could result in all jurisdictions abolishing their more interventionist regulations such as interest rate caps. If so, a convergence of the Member State laws towards the lowest common denominator could be the result. Large incumbent credit providers might be willing to pursue this strategy, if their bet is that they could realise a deregulation of consumer credit in the short to mid term. During that period they may not lose many customers, as customer immobility is likely to be strongest in the short to mid term.

It is unclear whether the hypotheses formulated above on the positions of members of the financial industry on mutual recognition and the country of origin principle coincide with actual positions, as members of the financial industry have so far not publicly expressed their views on such issues. The fact that EBF and EBIC have not put forward any position on mutual recognition and the country of origin principle might point to a lack of consensus among members of the financial industry. Therefore, it may not be ruled out that at least some credit providers are in favour of application of these principles to issues covered by the CCD and issues that are not. For instance, it is remarkable that the European Financial Services Roundtable (EFR), which consists of 19 large banks, states in one of its papers that targeted full harmonisation of key issues combined with the country of origin principle for non-key issues is Europe’s best bet for the short- to mid-term future.68 In the same paper the EFR also enumerates some advantages and disadvantages of the country of origin principle. It mentions as advantages the incentive it would create for Member States ‘to adapt their national rules if they risk the outflow of firms to Member States with regimes that offer a more balanced approach to consumer protection’ and the pressure it would place on Member States ‘to agree on harmonised rules because of the risk they face that firms will move to other Member States’. While not constituting conclusive evidence that the EFR supports the application of the country of origin principle to all issues not covered by the CCD, EFR’s paper

68 EFR, above n 32, at 30.
seems to suggest that (at least some of) its members might be sympathetic to the application of the country of origin principle.69

Nevertheless, even if some members of the financial industry favoured application of the country of origin principle to consumer credit regulation, they may not overtly support such a principle for at least two reasons. First, incumbent credit providers may not do so, as outright support of developments that could lower the general level of protection of consumer borrowers in their home markets could seriously undermine their reputations. This may make them hesitant to express their positions. Second, there may not be broad political support for application of a country of origin principle. The row that followed the Commission’s proposal in the framework of the services directive to apply the country of origin principle to rules affecting the cross-border provision of services70—including general rules of contract law—has turned the sentiment of the Member States against application of such a principle. Although the Commission had proposed to apply the principle of mutual recognition only to a few provisions of the CCD, a large majority of the Member States was opposed to the mutual recognition clause. They preferred the application of Art 5 of the Rome Convention to consumer credit contracts.71

The Council deleted the mutual recognition clause in its common position. An interesting detail is offered by the position of Luxembourg, which abstained from voting on the common position.72 In a press release the Luxembourg Minister of Economy and Commerce stated that Art 5 of the Rome Convention hampers the extension of cross-border credit by Luxembourg credit providers, who have to comply with 27 different national laws, and that Luxembourg consumers have much less choice of credit products.73 What the Luxembourg Minister pointed out is that the cost burden of the divergence of legal regimes impacts on smaller countries more heavily, where the opportunities for economies of scale are more limited.74

Favouring a country of origin principle to realise a convergence of the laws of Member States toward lower standards, may also be a dangerous strategy to follow. Such a strategy could only be successful if Member States were indeed willing to lower their standards of consumer protection. However, Member

69 Deutsche Bank has expressed itself in favour of ‘rigorous application of the mutual recognition principle’ in at least one paper emanating from it. See Deutsche Bank Research, ‘EU Monitor 34: EU Retail Banking, Drivers for the Emergence of Cross-border Business’, 17 April 2006, at 6–8.


71 Summary of written replies by Ministers to the Council Presidency in preparation of the Council Meeting on Competitiveness of 29 May 2006 (Note 9332/06), 26 May 2006. Unfortunately, the note does not indicate which Member States took what position.


74 See also EFR, above n 32, at 15.
States have hitherto not only gone beyond the minimum requirements of the CCD, but they have also introduced rules, either in the form of laws or as a result of court judgments, that interfere with the freedom of contract of debtors and creditors with a view to protecting the consumer borrower against unfair contract terms. A report by Reifner et al points out that many Member States offer consumer borrowers some form of protection against early termination of the credit contract by the creditor; at least Austria, Belgium, Denmark, Germany, Greece, Italy, Luxembourg, the Netherlands and Sweden have some form of regulation of default interest rates; and general and special interest rate ceilings exist in Belgium, France, Germany, Greece, Ireland, Italy, the Netherlands, Portugal and Spain. Responsible lending, on the other hand, has been much less the subject of regulation in the Member States. Nevertheless, Member States’ legislatures are likely to be more progressive when it comes to the adoption of rules on responsible lending than the European legislature.

Even though the final text of the amended CCD no longer provides for mutual recognition, the CCD may still have a stifling effect on the development of consumer protective rules insofar as it introduces maximum harmonisation. The amended CCD maximally harmonises the rules on pre-contractual and contractual information and the rules on credit advertising to the extent that credit advertisements include information on the cost of credit. Especially at the advertising and pre-contractual stages, the required information is limited, which coincides with the wishes of the financial industry to limit the provision of information at these stages. Member States cannot require credit providers to include more information. This may stifle the development of other, potentially useful, ways of providing information to prospective borrowers in these stages of the sales process. For instance, Member States may not be able to prescribe that credit providers include certain warnings in their advertisements or pre-contractual information, such as warnings on the risk attached to a particular loan or on the risks associated with variable interest rates.

Yet the CCD does not apply the maximum harmonisation approach to all issues covered. Moreover, many issues of consumer credit fall outside the scope of the CCD. For one thing, post-contractual information falls outside the CCD’s scope. This means that Member States can impose post-contractual information duties on credit providers. Specifically with respect to overdraft facilities such as

76 Ibid at 100–01.
77 For instance, the Assistant Secretary of Social Affairs and the Minister of Finance of the Netherlands have recently proposed that the creditworthiness test to be performed by credit providers should take into account a social minimum that should remain in place after deduction of the costs of the loan. In addition, they have announced that the registration of consumer debts will be extended to the registration of arrears in payment of rent for social housing, energy bills, and possibly other debts. See ‘Voorkomen overkreditering en schulden’, letter by Assistant Secretary of Social Affairs and Minister of Finance to the Chairman of the Second Chamber of Parliament, 10 October 2007.
credit cards, post-contractual information may fulfil an important role. Given that consumers often consider credit cards as a means of payment and may fail to take into account the costs associated with buying on credit, post-contractual warnings that highlight such costs, or indicate the costs associated with missing an instalment payment, might arguably have an effect on consumers’ spending behaviour. In addition, Member States remain free to apply provisions of the CCD to areas not covered by it.\(^7\) For instance, even though home loans fall outside the scope of the CCD, Member States can voluntarily apply provisions of the CCD to home loans. Furthermore, the amended CCD leaves it to the Member States to take measures that promote responsible lending practices and to require credit providers to offer explanations to consumers on their credit products.\(^9\) Finally, the more interventionist regulations such as interest rate ceilings fall outside the scope of the CCD, so that Member States remain free to draft their own policies in these fields.

VI. CONCLUSION

The final text of the revised CCD is unlikely to meet the ambitious goal of the Commission of fostering a vibrant EU-wide consumer credit market while, at the same time, guaranteeing a high level of consumer protection. Owing to the watering down of the Commission’s initial proposal, the revised CCD will not bring the price transparency required to remedy information asymmetry problems in consumer lending. The disclosure rules as embodied in the final text reflect many of the positions put forth by the financial industry. The financial industry’s lobby—as evidenced by the positions made public by EBIC, EBF and the like—aimed to exclude cost elements, notably insurance premiums, from the total cost of credit and to limit information provision in the early stages of the sales process.

This Chapter has suggested that incumbent credit providers might resist full information disclosure with a view to maintaining their current business models, which rely on cross-selling, bundling, product tying, cross-subsidisation, and consumer lock-in due to high closing charges. In their home markets incumbents stand to lose market share to smaller rivals and new entrants who compete on the basis of price. Thus, incumbents’ current resistance towards stricter disclosure rules might be informed by their inclination to protect their home market shares.

While incumbent credit providers may currently be focused on maintaining their home market share, new entrants and smaller rivals may have different interests to look after. A lack of price transparency in the early stages of the sales process adds to switching costs for consumers, which in turn hamper effective

\(^7\) See above n 4, recital 10.

\(^9\) See above n 4, recitals 26–7.
price competition by new entrants and smaller rivals. Therefore, new entrants and smaller rivals that want to compete on the basis of price may favour a higher level of price transparency to attract new customers.

Still the question arises as to whether incumbent credit providers might come around to supporting strict disclosure regulation in the longer run. Many incumbents are faced with the need to expand their businesses in other markets, including those of other Member States. Greenfield entry in other Member States is made more difficult with high customer immobility. Improving price transparency in the early stages of the sales process contributes to an increase in customer mobility. Incumbent credit providers that want to grow organically should therefore embrace stricter disclosure regulation to be able to compete on the basis of price.

Turning to the issue of mutual recognition and the country of origin principle, this Chapter has suggested that at least some credit providers might be in favour of application of these principles to all laws and regulations affecting consumer credit. As the Luxembourg Minister of Economy and Commerce has pointed out in his reaction to the Council’s decision to delete the mutual recognition clause, the cost burden of the divergence of legal regimes impacts on credit providers in smaller countries more heavily. Credit providers with small home markets might be the first to favour application of mutual recognition or the country of origin principle, as lowering the costs of legal compliance reduces the costs of cross-border credit extensions. However, these principles may only lead to a meaningful reduction in the costs of legal compliance if they applied to all rules and regulations affecting consumer credit. After all, many Member States have implemented consumer regulations, notably interest rate regulations, that fall outside the scope of the CCD. If mutual recognition or the country of origin principle were only to apply to the provisions included in the CCD, the decrease in legal compliance costs may not be sufficient to render cross-border credit extensions attractive.

Although credit providers with small home markets or located in low-standard Member States seem natural proponents of mutual recognition or the country of origin principle, it cannot be ruled out that other credit providers, notably incumbents, might also be in favour of application of these principles. As suggested in this Chapter, incumbent credit providers could be in favour of the application of these principles with a view to lowering the standards of consumer protection in their home markets. Currently, Member States are free to introduce interventionist rules such as caps on interest rates and rules on responsible lending. Moreover, many Member States already have some form of regulation of interest rates. If the principle of mutual recognition or the country of origin principle were to apply to those types of regulations, a deregulation of interest rates similar to the one that took place in the United States after the 1978 Marquette decision of the United States Supreme Court could also ensue in the EC. However, such a deregulation should not be welcomed so long as the annual percentage rate of charge cannot serve as an all-inclusive price tag. An
annual percentage rate of charge that does not include all fees and charges opens the door to misleading and abusive pricing of credit. Moreover, owing to consumers’ cognitive biases, disclosure rules may chronically fall short of effectively informing consumers on the price terms of credit products. If so, regulation of interest rates and other charges may be needed to address the issue of extortionate credit fees.

Nonetheless, Member States are still opposed to application of mutual recognition or the country of origin principle to all consumer credit laws and regulations. Hence, ample room exists both at the Member State level and the EC level to find a combination of disclosure regulation, rules on responsible lending, and possibly more interventionist rules that strikes an optimal balance between facilitating economically useful credit extensions and protecting borrowers against lender abuse. Yet finding an optimal balance is the biggest challenge policymakers have faced in the history of consumer credit.
Disclosure as an Imperfect Means for Addressing Overindebtedness: An Empirical Assessment of Comparative Approaches

SUSAN BLOCK-LIEB, RICHARD WIENER, JASON A CANTONE AND MICHAEL HOLTJE

Within a generation, household overindebtedness has grown to become a social problem of significant proportions. Legislative responses to the problem of overindebtedness—in the United States, the United Kingdom, New Zealand, Australia, the Republic of South Africa, and other nations—generally reform both consumer credit laws and the procedures for settling and collecting defaulted consumer debt. We focus on credit card disclosure reforms in this Chapter and note that empirical research (ours and others) suggests that enhanced disclosure requirements are, at best, an incomplete mechanism for tackling the problem of overindebtedness. A rational actor model of consumer behavior assumes that people who act with complete information will choose outcomes that maximize their benefits and minimize their costs. Disclosure regulation provides additional information to a less-than-perfectly informed borrower so that his decisionmaking can improve. Most disclosure regimes require issuers to provide price and other contract terms in a format that permits comparison with other sellers’ terms, on the

1 Since this Chapter was submitted for publication in March 2008, the US Federal Reserve Board took further action on the proposed revisions to Regulation Z discussed here. Truth in Lending; Proposed Rule, 12 CFR 226, Docket No. R-1286, 73 Fed. Regis. 28866 (19 May 2008). Relatively minor changes to the proposed revisions were detailed in this publication, but due to publication deadlines these additional remarks have not been incorporated in this Chapter. Final rules on open-end credit under Reg Z and the Truth in Lending Act have been promulgated by the Fed, and become effective as of 1 July 2010. Truth in Lending; Final Rule, 12 CFR 226, Docket No. R-1286, 74 Fed Regis 5244 (29 Jan 2009).

theory that consumers will then more wisely shop for credit. When aimed at overindebtedness, disclosure regulation also requires information about the consequences of mounting debt either monthly or upon default.

Enhanced disclosure is unlikely on its own to resolve a society’s overindebtedness. If imperfectly rational borrowers’ overindebtedness is explained by a simple lack of information about the consequences of default, how effective will it be to provide information about these consequences after default has already occurred? And if consumers’ deviation from the rational actor model goes beyond imperfect information to reach much more fundamental and natural psychological phenomena, why should additional information resolve these biases?

Competing models of consumer behavior are not simply issues of academic interest. They imply competing models of legislative action in a global battle against overindebtedness. In this Chapter, we look at how the United States and the United Kingdom have approached the problem of overindebtedness and the role of disclosure in each set of policies. Part I compares household indebtedness—and measures of overindebtedness—in the US and the UK. Part II looks at recent legislative responses to this problem, and concludes that the US approach is premised on a rational actor model of consumer decisionmaking, while the UK presumes a consumer in need of regulatory protection, enhanced information and debt advice. In earlier articles, both together and with other co-authors, we have argued that extant data do not support fundamental assumptions underlying a rational actor model of consumer credit but do support models that view consumer borrowers as quasi-rational, emotional actors. In Part III, we describe our most recent experimental work and its results, and reach similar conclusions about the likelihood that enhanced disclosure will quell the problem of overindebtedness. In Part IV, we draw tentative conclusions for future research intended to study overindebtedness.

I.

Despite the fact that there exists no accepted conceptual definition of the term ‘overindebtedness’, there is some indication that overindebtedness has grown over the past generation. Consumer credit, especially credit card credit, has grown exponentially over this period in both the UK and the US. In its White Paper on the Consumer Credit Market, the Department of Trade and Industry


4 Block-Lieb and Janger, above n 2.
notes that, while UK households owed £32 million in credit card debt in 1973, that figure had increased to £49 billion by 2003, representing on average about £1,950 in such debt per household. The US Federal Reserve Board indicates a similar trend. In December 1973, US households held roughly $11 billion in revolving consumer credit (largely credit card debt); by the same time in 2003, this number had jumped to $770.5 billion—about $6,950 in credit card debt per US household.

Some have argued that the growth in consumer credit is the healthy result of expanding access to credit that permits markets to meet demand and diminish credit constraints. However, data also present evidence of the potentially negative consequences to the so-called democratization of consumer credit.

For example, during roughly the same period, the US Federal Reserve calculates that the household debt service ratio increased from 10.92 per cent in 1980 to 14.33 per cent in 2007, and that the financial obligations ratio increased from 15.75 per cent in 1980 to 19.32 per cent in 2007. Between 1981 and 2005, when the bankruptcy law was significantly rewritten, US non-business bankruptcy petitions increased from 313,000 to more than 1.75 million petitions.

While there are no directly comparable statistics provided for UK households, the Department for Business Enterprise and Regulatory Reform reports in its 2007 Household Debt Monitoring Paper that "debt is becoming a problem for

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7 Federal Reserve Bank, Federal Reserve Statistical Release, Consumer Credit Historical Data, Table G.19, available online at <http://www.federalreserve.gov/releases/g19/hist/cc_hist_r.txt>.


12 The Fed’s ‘Financial Obligations Ratio’ builds on its debt service ratio by adding ‘automobile lease payments, rental payments on tenant-occupied property, homeowners’ insurance, and property tax payments to the debt service ratio.’ Ibid.

13 Ibid.

an increasing number of households’, both because the ‘debt to disposable income ratio across the household sector continues to increase’ and the ‘level and rates of debt write-offs have continued on an upward trend, especially debt written off on credit cards.’ The UK debt-to-disposable income ratio, which rose to 152 per cent in the second quarter of 2007, is not comparable to the US debt service ratio; nonetheless, the UK figures are troubling because an increase in the debt-to-disposable-income ratio has been correlated with increased mortgage and credit card delinquencies, and because the UK leads the US (and many other developed countries) in both debt-to-income and debt-to-assets ratios. Bankruptcy filings have risen steadily in the UK. Although both overall and as a function of population, UK filings do not approach US figures, the rates are still troubling since ‘personal statutory insolvencies in England and Wales have almost quadrupled since the beginning of 2000’ to the beginning of 2007.

II.

The problem of overindebtedness has not escaped the attention of legislatures around the globe. We focus on the responses taken by two countries—the US and the UK—although we comment occasionally on similarities in approaches taken by other countries.

A. The US Approach to Overindebtedness

In 2005, the US enacted the Bankruptcy Abuse Prevention and Consumer Protection Act (BAPCPA), designed to limit consumers’ access to and increase the cost of liquidation-type bankruptcy procedures. BAPCPA requires individual debtors to obtain credit counseling within 180 days before filing a petition

16 Ibid.
17 Ibid at 15. The UK ratio compares overall debt figures to overall income levels while the US figure looks to assess the difficulties households are experiencing in making their monthly debt obligations.
and to attend a course on personal financial management before receiving a
discharge. It superimposes a ‘means test’ for liquidation-type bankruptcy
eligibility to ensure that only those individuals presumed unable to repay their
debts out of disposable income are eligible for such relief. It also imposes addi-
tional disclosure requirements on open-end credit, by substantially amending
the Truth in Lending Act (TILA). Recently, the US Federal Reserve Board pro-
posed broad-ranging revisions to Regulation Z, the administrative rule that
implements TILA disclosure requirements. These revisions would combine
implementation of the BAPCPA-mandated enhanced disclosure requirements
with a broad-ranging overhaul of the regulations governing open-end credit
(comprised predominantly of credit card credit).

Proposed Reg Z would alter the content and format of required disclosure
substantially. Current law requires that, at the time a consumer receives a credit
application or solicitation, some (but not all) information must be pre-
sented in a table format (the so-called ‘Schumer Box’). The boxed terms are
intended to highlight for consumers information about key costs and terms so
they can compare credit offerings easily. An example of a Schumer Box appears
in Figure 8.1.

Credit card issuers are also required under current US law to supply more
detailed disclosures once the consumer actually opens the credit account. Reg Z,
thus, presumes that consumers comparison shop for credit cards based on the
key terms disclosed in solicitation materials, but make final credit decisions only
after receiving more fulsome disclosure information with the ‘offer’ of a card.
As such, it is predicated on the assumption that consumers engage in continual
and objective cost/benefit analyses.

Proposed Reg Z would require issuers to refer to penalty pricing in a credit
application or solicitation in a Schumer Box format. It would also require issuers
to add to the Schumer Box information about how issuers’ credit allocation

24 11 USC § 707(b) (2005).
25 15 USC §§ 1601 et seq (Title I of the Consumer Credit Protection Act of 1968). See also Federal
default.htm>.
26 15 USC §§ 1601 et seq (Title I of the Consumer Credit Protection Act of 1968). See also Federal
default.htm>.
27 15 USC §§ 1601 et seq (Title I of the Consumer Credit Protection Act of 1968). See also Federal
default.htm>.
R-1286, 12 Code Federal Regulations Part 226, 72 Federal Register 32948 (14 June 2007), available
online at <http://www.federalreserve.gov/dcca/RegulationZ/20070523/sect1.pdf> (hereafter Proposed
Reg Z).
29 Ibid at 32949, citing Advance Notice of Proposed Rulemaking, 69 Federal Register 70925
(8 December 2004).
30 The content and format of this disclosure information was first proposed by New York’s
Senator Charles Schumer. This particular Schumer Box appears in the CreditBloggers website,
available online at <http://www.creditbloggers.com/2006/02/what_is_a_schum.htm>.
31 Proposed Reg Z, above n 27, at 32953.
CITIBANK DISCLOSURES

<table>
<thead>
<tr>
<th>Category</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>Annual Percentage rate (APR) for purchases</td>
<td>0.00% for 12 months from date of account opening. After that, 10.49% variable.</td>
</tr>
<tr>
<td>Other APRs</td>
<td>Balance transfer APR: As long as first balance transfer is completed within 12 months from date of account opening. 0.00% for 12 months from date of first balance transfer. After that, 10.49% variable. Cash advance APR: 22.49% variable. Default APR: 31.49% variable. See explanation below.*</td>
</tr>
<tr>
<td>Variable rate information</td>
<td>Your APRs may vary each billing period. The Purchases and balance transfer rate equals the U.S. Prime Rate** plus 2.99%. The cash advance rate equals the U.S. Prime Rate plus 14.99%, with a minimum cash advance rate of 19.99%. The default rate equals the U.S. Prime rate plus up to 23.99%.***</td>
</tr>
<tr>
<td>Grace period for repayment of balances for purchases</td>
<td>Not less than 20 days if you pay your total new balance in full each billing period by the due date.</td>
</tr>
<tr>
<td>Method of computing the balance for purchases</td>
<td>Average daily balance (including new purchases)</td>
</tr>
<tr>
<td>Annual fees</td>
<td>None.</td>
</tr>
<tr>
<td>Minimum finance charge</td>
<td>$0.50</td>
</tr>
<tr>
<td>Transaction Fee for Purchases made in a Foreign Currency</td>
<td>3% of the amount of foreign currency purchase after its conversion into U.S. dollars.</td>
</tr>
<tr>
<td>Transaction Fee for cash advances:</td>
<td>3% of the amount of each cash advance, $5 minimum.</td>
</tr>
<tr>
<td>Transaction fee for balance transfers:</td>
<td>3% of the amount of each balance transfer, $6 minimum, $75 maximum. However, there is no fee with the 0.00% APR balance transfer offer described above.</td>
</tr>
<tr>
<td>Late fee:</td>
<td>Late fee waived as long as you make a purchase or cash advance (balance transfers do not qualify) in the same billing period that the payment is due. Otherwise $15 on balances up to $100 up to $1,000; and $35 on balances of $1,000 and over.</td>
</tr>
<tr>
<td>Over the credit-line fee:</td>
<td>$29.</td>
</tr>
</tbody>
</table>

*Default APR: 31.49% variable. See explanation below.
**U.S. Prime Rate: The rates are subject to change. For more information, please call 1-800-424-6800.
***Cash advance rate: The rates are subject to change. For more information, please call 1-800-424-6800.

Figure 8.1 Example of a Schumer Box
methods affect credit costs so, for example, consumers are alerted that they will pay interest on their purchases until transferred balances are paid in full. The proposal also ceases to mandate some disclosure requirements, and shifts other required disclosure from inside the Shumer Box to outside so that it ‘does not detract from information that is more important to consumers’.

Perhaps the most significant proposed revisions to Reg Z would involve the disclosure required, not at the time of application or contract, but in each periodic statement. These disclosure requirements are most directly aimed at consumers’ overindebtedness. As required by BAPCPA, the proposed revisions to Reg Z would require credit card issuers to provide a warning statement regarding the effect of making only minimum payments on the time it will take to repay the consumer’s balance and the aggregate interest paid over time. It would also require a hypothetical example of how long it would take to pay a specified balance in full if only minimum payments are made, and a toll-free number that consumers could call to access more personalized estimates of the time it would take to repay their account balance by making only minimum payments. Proposed Reg Z would also require creditors to disclose payment-due dates and the amount of any late-payment fees on the front side of the periodic statement and to state expressly any cut-off time earlier than 5 pm.

The proposal would also revise the disclosure of fees and interest costs in periodic statements. Currently, Reg Z requires card issuers to disclose the ‘effective APR’, reflecting the cost of interest and certain other finance charges imposed during the statement period. Under the proposal, creditors could distinguish between ‘interest charges’ and ‘fees’. Because it suspects that the term ‘effective APR’ is misleading, or at least uninformative, to consumers, the Board asked for comment on the best method for improving consumers’ understanding of the concept of an ‘effective APR’ and for comment on the possibility of eliminating the term ‘effective APR’ altogether. If, in the end, the Fed were to eliminate the concept, the US would follow roughly in the footsteps of New Zealand and Australia.

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31 Ibid at 32954.
32 Ibid.
33 Ibid.
34 This warning is sometimes referred to as a ‘wealth warning’ that compares to the ‘health warnings’ provided on cigarettes and liquor.
35 Ibid at 32956.
36 Ibid.
37 Ibid at 32955. In addition, the proposal would also increase disclosure of changes to the interest rate and other account terms, and disclosure relating to credit card checks, credit insurance, debt cancellation, and debt suspension coverage plans. Ibid at 32958.
38 Ibid.
We list these proposed revisions to Reg Z, not so much to quarrel with their content—most of which we support—but rather to question both their sufficiency and the methodology that the Fed references in support. When first enacted, Congress described TILA as intended ‘to provide a meaningful disclosure of credit terms to enable consumers to compare credit terms available in the marketplace more readily and avoid the uninformed use of credit’.\textsuperscript{41} The Fed describes its motivation in revising Reg Z in slightly different terms, however:

To shop for and understand the cost of credit, consumers must be able to identify and understand the key terms of open-end accounts. But the terms and conditions affecting credit card account pricing can be complex. The proposed revisions to Regulation Z are intended to provide the most essential information to consumers when the information would be most useful to them, with content and formats that are clear and conspicuous.\textsuperscript{42}

By indicating that the ‘principal goal’ of Proposed Reg Z is to promulgate ‘disclosures that consumers will be more likely to pay attention to, understand, and use in their decisions’,\textsuperscript{43} the Fed acknowledges that not all consumers will read and process the information required by law to be disclosed. Indeed, it supports its revisions to Reg Z with empirical research on what forms of disclosure information communicate most effectively to different groups of consumers.

Conducting an empirical inquiry to determine how to best provide disclosure information is a step in the right direction and one that we applaud. The critical question from a social science point of view becomes: What questions should the experimenter ask and under what circumstances should they be asked? Unfortunately, the questions that the Fed asks in its commissioned research are questions that continue to posit a rational actor—a rational actor whose need for information about credit cards reduces to simple questions of preference: What disclosure information is ‘most essential’ and when would it be ‘most useful’? Disclosure regulation and marketing become hard to distinguish. Disclosure regulation is envisioned as telling consumers what they want to know and to do it at a time and in a format they are most likely to notice.

Given the regulatory perspective that disclosure regulation and marketing share a close nexus, it should come as no surprise that the Fed retained a research and consulting firm (Macro International) specializing in designing and testing documents.\textsuperscript{44} Macro combined exploratory focus groups, consisting of between 8 and 13 consumers, with ‘nine cognitive interviews with credit card customers’ to assess participants’ understanding of ‘existing credit card disclosures’.\textsuperscript{45} These initial focus groups and cognitive interviews were followed by

\begin{itemize}
\item \textsuperscript{41} Proposed Reg Z, above n 27, at 32948. See also 15 USC § 1601(a) (identifying secondary purpose for disclosure: ‘to protect consumers against inaccurate and unfair credit billing and credit card practices’).
\item \textsuperscript{42} Proposed Reg Z, above n 27, at 32953.
\item \textsuperscript{43} Ibid at 32951.
\item \textsuperscript{44} Ibid.
\item \textsuperscript{45} Ibid at 32951–52.
\end{itemize}
four additional rounds of cognitive interviews involving between seven to nine participants per round ‘where consumers were asked to view new sample credit card disclosures developed by the Board and Macro International’.46

We find the extent of the Fed’s reliance on focus groups and one-on-one interviews to determine consumers’ preferences for, and likelihood to read and understand, disclosure information, quite remarkable. Given the small size and other limitations in the pool of participants, we question whether the results of this research should be attributed to all US credit card users. Macro reports that it received input from only 86 individuals in seven locations.47 And while Macro reports diverse demographics from these participants, including a range of both ‘prime and subprime borrowers’, important groups are clearly underrepresented (for example, only 2 per cent of the participants were 61 years old or older, only 7 per cent were Hispanic or Latino, and only 1 per cent had not graduated from high school) and overrepresented (that is, more than 57 per cent of the participants had held a credit card for more than 10 years).48

More generally, we note that focus groups are not well regarded in the academy for assessing how individuals engage in decisionmaking.49 Although frequently used to conduct marketing research,50 even marketing research experts recognize the severe limitations of focus groups as compared to other means for empirical research regarding consumer behavior.51 Courts have flatly refused to admit focus group data as evidence under the Daubert standard.52

Social scientists recognize focus groups as a viable method to identify potential antecedents of decision outcomes, but reject focus groups as a method for testing the impact of input factors on decision outcomes. The essential problem lies with the inability of focus groups to test cause and effect relationships and

46 Ibid.
47 Macro International, Inc, Design and Testing of Effective Truth in Lending Disclosures, at Table 1 (listing Calverton, MD; Birmingham, AL; Baltimore, MD; Kansas City, MO; Denver, CO; Boston, MA; Dallas, TX) (17 May 2007), available online at <http://www.federalreserve.gov/dcca/regulationz/20070523/Execsummary.pdf>.
48 Ibid.
the inability of respondents to report how they actually use information to make their decisions. The Fed sought to resolve a summative issue (Does specific language presented in a specific manner result in a better comprehended message?) and not a formative issue (What are the needs and wants of consumers?). While focus groups and interviews are useful for investigating formative questions, they are no substitute for experimental trials to test the effectiveness of selected language and presentation style as a means of conveying an intended message. Ultimately, the issue becomes one of the reliability of a causal connection between specific types of enhanced disclose and consumer behavior, as directly observed. Unfortunately, empirical research demonstrates that the relationship between directly observed choice and decision measured under objective testing conditions may not correlate with self-reports of wants and needs identified in focus groups or even cognitive interviews.

In the end, the Fed came up with proposed revisions to disclosure materials based on the results of focus groups involving 44 consumers and nine one-on-one interviews. Then they conducted 33 follow-up cognitive interviews to measure consumer responses to the revised forms. It would be surprising to us if a convenience sample of 86 consumers constituted a representative sample of hundreds of millions of US households. Perhaps most importantly, it is difficult if not impossible for us to review the conclusions reached by Macro. Unlike peer reviewed articles, Macro provides no data in their publicly available report to support their conclusions.

B. The UK Tackles Overindebtedness

In an effort to counteract the problem of overindebtedness, the UK combined reform of consumer credit laws with initiatives to provide access to consumer debt advice and encourage out-of-court workouts of defaulted consumer debt. After an initial period of study, the DTI published a White Paper in 2003 on what it described as the growing problem of overindebtedness. To enhance transparency in consumer credit transactions, the White Paper proposed changes that would make advertisements clearer and simpler to understand and enforce, provide consumers with clearer disclosure information before and after credit agreements are signed, enable on-line credit agreements, and raise consumer awareness of, and limit penalties associated with, ‘early settlement charges’. The White Paper also advocated regulation to strengthen the existing credit licensing regime, tighten standards pertaining to unfair selling

54 See E Kempson, Personal Finance Research Centre, Over-Indebtedness in Britain: A Report to the Department of Trade and Industry (September 2002), available online at <http://www.pfrc.frisc.ac.uk/Reports/Overindebtedness_Britain.pdf>.
55 See DTI White Paper, above n 5.
56 Ibid at 5.
practices by prohibiting ‘unfairness’ in consumer credit transactions and providing dispute resolution mechanisms for enforcement of this prohibition, and remove the £25,000 ceiling on credit transactions covered by the Consumer Credit Act so that all consumer credit transactions would be governed by the same law. The White Paper focused specifically on overindebtedness when it proposed coordinated strategies for adding financial education to school curricula and making free debt advice widely available to consumers in financial difficulty. It also proposed the revision of insolvency laws and non-statutory remedies available for resolving consumers’ debt problems.

This was an ambitious range of proposals and the DTI sought to bolster its plan with empirical support. Although the DTI had studied the market for consumer credit extensively before making these proposals, in the spring of 2004 it also commissioned a private entity with links to the academy, MORI Financial Services (MFS), to ‘undertake one of the largest surveys to be carried out on consumer overindebtedness in Great Britain’, a survey involving the responses of 9,892 individuals. MFS, first, sought to develop a working definition of ‘overindebtedness’ by examining objective and subjective indicators of financial difficulty. MFS found that 9 per cent of surveyed individuals are spending more than half of their income on total credit repayments and 8 per cent are spending more than a quarter of their income on unsecured credit repayments; smaller percentages of the respondents had been in arrears for more than three months or considered their debt obligations a ‘heavy burden’. It determined that individuals who possess more than one indicator of overindebtedness ‘are typically those who earn less than £9,500 a year; are in their 20s or 30s; have children, and/or are renting accommodation’, and tentatively concluded that the ‘increase in the level of overindebtedness as measured by the objective indicators could be interpreted as a slight worsening of the situation’.

Since publication of its White Paper in 2003, DTI took steps to implement many of the reforms advocated in the White Paper. It established the Ministerial Group on Over-Indebtedness to coordinate the agencies involved in tasks associated with reducing and redressing overindebtedness. In 2004, 2005 and 2006, the

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57 Ibid at 5–8.
58 These strategies were to be coordinated among DTI, the Financial Services Authority, the Departments for Work and Pensions and for Constitutional Affairs, as well as the Departments for Education and Skills and for Communities and Local Government, and HM Ministry of the Treasury.
60 Ibid.
63 MFS was careful to note that the indicators are suggestive of overindebtedness, but do not define it per se. Ibid at 3–4.
64 Ibid at 5–7.
65 Ibid at 1, 12–13.
66 Ibid at 13 (comparing MORI Report to Kempson Report).
Ministerial Group published detailed annual reports on their progress,\(^67\) which discuss efforts to create a financial education curriculum in schools and workplaces,\(^68\) promote savings and asset ownership among low-income borrowers\(^69\) and responsible lending within the consumer credit industry,\(^70\) provide free debt advice to those who need it,\(^71\) and streamline various judicial procedures,\(^72\) including legislation to introduce Debt Relief Orders\(^73\) and Enforcement Restriction Orders.\(^74\)

By 2006, Parliament had adopted overarching reforms to the Consumer Credit Act of 1974.\(^75\) The scope of the Consumer Credit Act of 2006 (CCA) is broad, covering both ‘fixed sum’ and ‘running account’ credit transactions. It permits consumers to challenge ‘unfair’, not merely ‘extortionate’, lending transactions, as had been the case under former law, and to do so by means of the courts or through alternative dispute resolution mechanisms. The 2006 Act also streamlines the system for licensing providers of consumer credit and enforcing licensing requirements. The CCA also sought to enhance the information required to be provided to consumers both before and after consumer credit contracts are formed.

For purposes of this Chapter, we are most interested in the ‘post-contract’ disclosure obligations,\(^76\) especially those applicable to ‘running account’ statements.\(^77\) All periodic statements are required by the Act to contain basic information about the borrower (name and address), the lender (name, postal

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\(^72\) For a copy of the draft Tribunals, Courts and Enforcements Bill, see <http://www.dca.gov.uk/legist/tribenforce.htm>.

\(^73\) DROs are intended to provide redress for debtors, outside of bankruptcy, who have no means of ever repaying their debts and are unable to access currently available or proposed debt relief measures under UK law.

\(^74\) EROs would give debtors a period of breathing space in order to repay their debts over a short period of time.


\(^76\) Consumer Credit Act of 2006, §§ 6, 7, 9, 10, 12, 14, and 17 (hereafter ‘2006 CCA at §’).

\(^77\) A ‘running account’ statement correlates roughly to the periodic statements pertaining to ‘open-end’ credit under US law.
address and telephone number), the transaction (period of statement, account identifiers, amount of borrowing, application interest rates, date and term of agreement, opening and closing balance, payments made, and amounts due), and various rights owed to the consumer under the Act (regarding early payment and termination, and complaints procedures). The Act also requires warnings about the implications of not making required repayments or of only making partial or minimum payments in ‘running account statements’, similar to the warning added by BAPCPA to the US Truth in Lending Act. In addition, the Act requires further notification when a borrower is in arrears, which includes information about the implication of the default and various options for resolution of the defaulted obligations.

The CCA requires lenders in consumer credit contracts, including credit card contracts, to provide borrowers substantial amounts of information upon default—information about the event of default, the effect of default and the remedies available for collection and repayment of the defaulted obligation. These post-contract information requirements are clearly aimed at minimizing the impact of default, and so of overindebtedness. Because we know of no empirical research to support the notion that disclosure provided at the time of default is any more likely to alter consumer behavior than information received at an earlier point in time (that is, application, solicitation, receipt of periodic statement, and so forth), we suspect that disclosure provided at the time of default, at best, may affect consumers’ decisions about what to do after default occurs, but is unlikely to impact their ex ante borrowing and payment decisions.

III.

Our empirical studies of consumers’ decisions to purchase goods with credit cards, and the effect of disclosure on those purchasing and borrowing decisions, considers the role of emotion in consumer decisionmaking. Based on the pre-existing psychological literature, we expected the phenomenon of affective forecasting (predictions about one’s future emotional experiences), anticipated emotion, and mood repair behaviors to influence the credit-purchasing decisions of potential consumers. These processes stem from an acknowledgement that consumer purchasing is a psychological process that almost always occurs

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78 2006 CCA, above n 76, at § 6.
79 Ibid at § 7.
80 Ibid at §§ 9–10.
81 DTI, Final Report, above n 75, at 7.
in the context of an emotionally charged environment resulting from both external pressures and internal states.

With affective forecasting, people often overestimate the emotional consequences of outcomes, such as by overestimating the length of negative affect after an unwanted outcome. This is referred to as the ‘impact bias’. In a classic experiment, researchers found that assistant professors predicted much greater and longer unhappiness as a result of being denied tenure than former assistant professors who were denied tenure actually experienced.83 Similar results were found in experiments examining the break-up of romantic relationships and backing the losing party in gubernatorial elections in the US.84

Similarly, bias in affective forecasting can lead to ‘miswanting’, a situation in which people expect to enjoy the outcomes of their experience more than they actually do.85 People may overestimate the positive or negative emotional experience associated with an outcome because they anticipate an outcome that is different from the one that they actually come to experience.86 Some researchers argue that ‘focalism’, focusing too much attention on the specific future event and too little on the other life experiences that make up the context of that event, produces these inaccurate predictions.87 Others speculate that individuals may use the wrong intuitive theories to predict and explain the impact of life’s events on their emotional well-being, or that people incorrectly anticipate the feelings that they will experience.88

Research involving a gambling task found that expected emotions can predict the pleasant or unpleasant moods people actually experienced and that people make future decisions based upon the emotions they expect to feel independent of the actual outcomes of the gambles.89 Extensions of this research show how anticipated pleasure supplements the logic of rational decision-making in a variety of decision tasks in both real world and laboratory choices.90 More recent experiments agree with the general findings in the existing literature that anticipated affect can direct future choices.91

84 Ibid.
85 Gilbert and Wilson, ‘Miswanting’, above n 82.
86 Ibid at 180.
We believe that the results of these laboratory and real world studies of affective forecasting and anticipated emotion foreshadow expected deviations from a formal rational actor model in consumer decisionmaking as it applies to credit use and most specifically to credit card holders. We theorized that anticipated emotions would interact with the enhanced disclosure rules mandated in BAPCPA to influence consumers’ use of credit cards and that enhanced disclosure information might be the source of negative mood states for consumers. Enhanced disclosure information confronts credit card holders with large balances, high interest rates, and lengthy payoff periods, which could generate distress, especially for people who have not thought about these terms. If enhanced disclosure produces negative mood states, consumers may engage in mood repair activities. Some research suggests that people sometimes engage in shopping behavior to escape bad moods; one study found that debtors were more likely than non-debtors to shop to end a bad mood.92 If this is true and enhanced disclosure does produce negative affect, people may engage in more credit-purchasing to escape their negative moods.

Applying the existing literature and theories to consumer credit card use, we predicted that consumers who anticipated that positive feelings would result from making purchases and negative emotions would result from not buying would be more likely to make any given purchase. Similarly, we predicted that those who anticipate that negative emotions would result from making purchases, and that positive emotions would result from not buying, should be more likely not to make a purchase. While we expected that enhanced disclosure rules would act to dampen consumer spending with credit cards, we expected this to occur only when the consumers’ emotional experiences acted in conjunction and not in opposition to the disclosure rules. In addition, we investigated if enhanced disclosure produced negative moods and if consumers made credit card purchases to repair or offset those negative moods.

To test our hypotheses, we conducted an online field experiment93 to examine the effects of enhanced disclosure and self-reported emotion on the credit card purchasing behavior among people who had filed petitions for bankruptcy relief in the prior year (debtors) and among people who had not filed for bankruptcy (non-debtors). We hypothesized that enhanced disclosure would prevent non-debtors (and, to a lesser extent, debtors) from overusing simulated credit cards. We also expected the emotional reactions toward enhanced disclosure information to moderate the effects of enhanced disclosure on purchasing and borrowing behavior.

93 The experiment was an analog study which simulated credit card purchases made online. Generalizations of results of analog studies to real-world behavior are difficult to make without replication. However, experimental psychology models, such as the one we have developed in this Chapter, have proved to make valuable contributions to policy analysis in many areas, including eyewitness identification, jury decisionmaking, and discrimination research. Ibid.
We recruited debtor participants through PACER, an online record-keeping system that lists all bankruptcy filers and their cases. We selected random samples of debtors from Nebraska and greater New York City, who had filed bankruptcy petitions in one of seven months prior to our experiments, and we mailed fliers to them advertising the research and inviting them to participate in an online study in exchange for a $10 stipend. We also distributed fliers at court and with attorneys and bankruptcy trustees. We recruited non-debtor participants through newspaper advertisements in both the New York City and the Omaha and Lincoln, Nebraska communities. Each participant could enter the study website on a computer of his or her choice.

For both consumer debtors and non-debtors, we investigated purchasing decisions made during a simulated on-line shopping trip. All research materials appeared on a website, which included an informed consent statement, a disclosure information manipulation (enhanced or enhanced disclosure), a PANAS survey measuring emotion,94 an anticipated-affect manipulation, a simulated on-line shopping trip task, and a demographic sheet. The simulated shopping trip emulated a common on-line shopping experience, where consumers used a hypothetical ‘Goldwave’ credit card to make purchases. Prior to the shopping trip, the website displayed a general set of instructions, describing the simulated shopping trip and detailing how to use the ‘Goldwave’ credit card.

Determined at random, one half of the participants received unenhanced disclosure information, consisting of a credit card balance, the interest rate, and the minimal payment due (prototypical information available to consumers prior to BAPCPA). The other half of the participants viewed enhanced disclosure information that reflected full and individualized disclosure, including a clear and concisely written statement explaining how many minimum payments they would need to make to pay off credit card balances at increasing increments of $1,000.00 (from $1,000.00 to $15,000.00). Enhanced disclosure detailed how much principal credit card users would pay, how much interest they would pay, and an estimate of how many months would elapse before the balance reached zero. The statement came both in the form of a chart and a narrative description of the chart’s elements.

After viewing one of the two disclosure forms, each shopper completed a short version of the PANAS, a standardized measure of currently experienced positive and negative affect.95 Participants then engaged in our online shopping task, which offered them 10 items that they could consider for purchase. Respondents examined each item and rated the likelihood that they would buy that item with their ‘Goldwave’ credit card (on a 1—very unlikely to buy—to 8—very likely to buy—scale).

95 Ibid.
In order to manipulate anticipated emotions about purchasing with their ‘Goldwave’ credit card, we assigned participants at random to one of four experimental conditions, each with a different type of anticipated emotion. Three fourths of the participants were asked to imagine how they would feel if they made or did not make a purchase in the simulated online shopping trip. In the neutral purchase condition, participants first imagined that they did buy a product and recorded what they expected to feel. Next, they imagined that they did not make the purchase and recorded their expected feelings. In the pleasant purchase condition, participants’ anticipated emotion was manipulated by the study design. They were told to imagine that they did buy the item and that they felt good about that decision. Similarly, the design manipulated anticipated emotions in the unpleasant purchase condition. Those participants were told to imagine that they did make the purchase and that they felt badly, and then instructed to imagine that they did not buy the product or service and that they felt good. Finally, the remaining participants in the control purchase condition made purchasing decisions without any instructions regarding their emotional reaction to the purchases. This last group of participants simply made decisions about whether or not to purchase the items without any directions regarding expected emotions. In this manner, the experimenters created anticipated emotions in the minds of the consumers at the time of purchase.

At the conclusion of the shopping trip, the participants again completed the PANAS-X short form and then answered a series of demographic and financial questions, including their current financial status, credit use, normal purchasing behavior, and knowledge of credit card borrowing. We used the financial questions to test how much participants knew about borrowing and interest rates and to look at the relationship between our enhanced disclosure information and knowledge of credit use.

The experimental results demonstrated the influence of anticipated affect in credit card use among both debtors and non-debtors, and indicated that anticipated emotion may moderate the impact of the enhanced disclosure regulations. The main analyses did not find statistically significant differences between debtors and non-debtors measured in terms of either their likelihood to buy (average ratings of likelihood to buy across the 10 items) or their expected expenditures (likelihood to buy ratings weighed by the costs of the items), but did show statistically significant enhanced disclosure effects. Those with enhanced disclosure (as compared to those without) were less likely to buy products and showed lower expected expenditures. However, the effects of enhanced disclosure did not seem to work through the influence of debtor knowledge about credit card use. Specifically, there was no statistically significant difference in likelihood to buy or expected expenditures for either debtors or non-debtors as a function of their scores on the credit knowledge scale. This

96 For more detailed results from the experiments, see authorities cited in above n 3.
result challenges the rational choice model as a complete theory of consumer behavior and as a model of policy formulation. It suggests that future reform of the existence, timing or content of disclosure information should account for factors in addition to consumer knowledge of credit terms and their implications for credit use.

These studies also support the role of distorted affective forecasting or anticipated emotion after credit card use among both debtors and non-debtors. Participants whose affective predictions led to more positive expectations of feelings following purchases were more likely to buy items with a credit card on a simulated shopping trip as compared to those whose affective predictions led to more negative feeling expectations following purchases. This difference was statistically significant. Although we found that the effects of enhanced disclosure were also significant on the likelihood of buying measures for the debtors, our attempts at enhancing minimum payment disclosure information had only a small but significant effect on likelihood to buy. Furthermore, when we multiplied the costs of the items by the likelihood of buying to create an expected expenditure measure, enhanced disclosure was only partially effective in dampening credit card use. With this measure, anticipated emotion moderated the effects of disclosure on expected expenditures so that the disclosure effects (reduced spending) were only found for the condition in which debtors’ anticipated neutral feelings following purchasing. Disclosure failed to exert any statistically significant impact when debtors anticipated either positive or negative emotion after purchasing. Thus, in our experiment the significant effects of disclosure on debtors were limited to conditions in which anticipated emotion was neither positive nor negative.

Whether or not people professed to shop to end bad moods moderated the effects of enhanced disclosure in a troublesome way. Individuals who claimed to shop to end bad moods showed significantly higher likelihood-to-buy ratings and greater expected expenditures. Most importantly, the general effect of enhanced disclosure (decreasing credit card purchases) boomeranged among those who shop to end a bad mood. These debtors and non-debtors, as compared to those without enhanced disclosure, were significantly more likely to buy and showed higher expected expenditures on our shopping trip.

This suggests a moderating effect for enhanced disclosure. While it may decrease credit card purchasing among individuals who do not shop to end bad moods, for those individuals who self-report that they shop to control their moods, enhanced disclosure may actually become one more reason to shop more. Making consumers aware of the delayed punishment for consuming in harmful ways (that is, increased costs from compounding interest) may create fear and anxiety that offset any small gains obtained in the wise use of money.

In our experiment, those who admit to shopping to end bad moods failed to gain much new knowledge from their exposure to enhanced disclosure information but they did experience the affective ‘pain’ that comes with that increased knowledge. Most importantly, these individuals wound up using their credit
cards more and spending more money on our simulated shopping excursion. Increases in credit card loan knowledge did not lead to curbed use of credit, enhanced disclosure did not increase loan knowledge, but enhanced disclosure did increase negative affect, which is indirectly associated with increased credit card use. Individuals who bought more on the simulated shopping trip experienced a statistically significant decrease in their negative affect over the course of the shopping expedition. Our experiments suggest that relying on disclosure to regulate consumer spending may need to consider the effects of mood repair shopping as a natural outcome of enhanced disclosure.

These results suggest that regulators should not rely on disclosure alone to modify consumers’ credit card decisions: choices among credit cards, point of purchase decisions, judgments about how much to pay monthly, and decisions about what do in the face of overindebtedness, delinquency, or default. Additional research is needed to test this effect in a more naturalistic environment and to develop disclosure methods that do not increase levels of anxiety so high as to trigger ‘feel better’ purchasing.

IV.

Simply enhancing the amount of information in credit card disclosures may be insufficient to remedy a consumer’s overspending. This insight challenges the assumption, implicit in both BAPCPA and, to a lesser extent, in the CCA, that with more information about credit terms, consumers will modify their purchasing behavior and resist pressures to overuse their credit cards. Future research will need to explore how consumers make decisions about credit cards, and expand theoretical understanding of how psychological factors impact those decisions and how the presentation of disclosure information can affect the process. Both analogue purchasing studies and survey research will be needed to examine the roles of anticipated and experienced emotion on the use of credit and to identify strategies that help regulators design disclosure laws and consumers make use of that information.

In the research described in this Chapter, we studied the impact of disclosure about the costs of high interest rates and minimal payments on consumers’ decisions to make credit card purchases, and the effect of anticipated emotion on the effectiveness of that disclosure. Our studies, which mimicked the disclosures required by BAPCPA and provisionally incorporated into Reg Z, suggest that, at best, disclosure can be expected to have modest effects on purchasing decisions and, only then, under circumscribed conditions. These results are statistically significant, but, like all research, replication and extension would be desirable.

BAPCPA requires enhanced disclosure in application materials and in periodic statements about the effects of making only minimum payments. The UK takes a very different approach to disclosure as a means of redressing
consumers’ overindebtedness. The CCA requires enhanced disclosure of options available to consumers in the event of delinquency or default. This disclosure information is coupled with broad government assistance for financial education, debt advice and other remedies. Although we are sympathetic to the impulse to help consumers with additional information, we suspect that disclosure after a delinquency or default is unlikely to affect consumers’ credit card purchasing activity. Indeed, we are skeptical that post-default disclosure will impact consumers’ repayment or default behavior except at the margins. We know precious little about the psychological mechanisms responsible for the successful impact of enhanced information provided to consumers in the emotionally laden context of credit card use.

Although providing consumers with information about their options, and providing government support for various remedies, surely is better than no intervention, delinquency and default are likely to create strong emotions in the minds of borrowers. Our studies suggest that even the anticipation of that emotion could moderate and possibly counteract the effects of strongly worded and well-designed disclosure. Future research will need to study the relative effectiveness of information provided at different points in time along the purchasing and payment continuum, in the context of emotional and motivational psychological factors.

Future research should also focus on the effects of disclosure on credit card selection, an important focus of the CCA, TILA and many of the revisions in Proposed Reg Z. This research should take into consideration the need for a rigorous methodology to understand the psychology of semi-rational choice in determining the selection of credit card agreements and the use of those cards that would go beyond the limited methodology of focus groups and self-report that characterize the Fed’s investigation.97 This research should involve several stages, beginning with a computer program that presents consumers with credit card agreements that differ as to APR, penalties, interest rates, minimum payments, and default definitions. The program would keep track of the type and amount of information that consumers select while they are trying to reach a decision, and record the amount of time that respondents take when considering the information from each category, the order of category selection, and ultimately their final choice. The conclusion of this phase would provide a sample of information that consumers use in making choices. The next phase would test the relationship between the mandated disclosure information and consumer behavior regarding use of the card. Based on the results of the first phase, the experimenters could manipulate the information presented, the format of the presentation, the description of the information, the emotional states of the choosers, and the motivational states of the consumers. Additional experiments could include psychological manipulations, as well as measures of

motivational (for example, prevention vs promotion focus) and emotional states (for example, surprise, anger, fear, and happiness, both anticipated and experienced) to begin to determine how the psychology of judgment and decisionmaking deviates from a purely rational actor approach. In the end, we would anticipate that the advertisements and agreements that result from such a plan would incorporate the psychological dimensions of consumers trying to decide what credit cards to purchase.

V. CONCLUSION

Overindebtedness is a growing societal problem in the US, the UK, and around the world. Public policy makers have taken initial steps to ameliorate excessive and unwise use of consumer credit, which often include the provision of enhanced disclosure to borrowers. Our earlier research suggests that, standing alone, disclosure may be an insufficient regulatory response to this problem, but more conclusive findings await future empirical research. We invite other social scientists to use state-of-the-science methodologies to test the assumptions, implicit in a rational actor model of consumer behavior, which underlie these recent policy revisions. It is only with this concentrated effort that effective tools for reducing overindebtedness should be developed.
Prevention of Overindebtedness and Mechanisms for Resolving Overindebtedness of South African Consumers

MICHELLE KELLY-LOUW

I. INTRODUCTION

The NATIONAL CREDIT Act 34 of 2005 (and its Regulations) is the product of an intensive legal comparative project by the South African Department of Trade and Industry and represents a major departure from the previous South African credit regulation regime. It aims to solve specific problems in the existing South African consumer credit market, including the prohibition of reckless lending by credit providers, the prevention and alleviation of overindebtedness of consumers, and the prevention of high costs of credit.

This Chapter initially discusses why the previous credit legislation became outdated and ineffective for the existing credit market. A brief background to the National Credit Act is then provided. Specific attention is given to the provisions that have been included in the Act to prevent consumers from becoming overindebted; and the mechanisms that have been included to resolve the overindebtedness of consumers. Reference is also made to a recent survey which indicates the impact of the National Credit Act on ordinary consumers.

II. REPEALED LEGISLATION

The South African consumer credit legislation previously consisted principally\(^1\) of the Usury Act 73 of 1968\(^2\) and the Exemption Notices (of 1992 and 1999)

\(^1\) Another piece of legislation that also governs financial transactions by consumers is the Alienation of Land Act 68 of 1981.

\(^2\) Hereafter ‘the Usury Act’.
issued in terms of section 15A of the Usury Act, and the Credit Agreements Act 74 of 1980.\(^3\)

The Usury Act covered money lending of up to ZAR500,000 and capped the interest rates for these loans. The Usury Act provided that basic disclosures had to be made to consumers (that is, borrowers). However, only selective disclosures were made and not all the costs of credit were disclosed. In practice, only the interest rates were disclosed, there were no penalties for non-compliance and the Usury Act was not enforced. Over the years the Usury Act became outdated. For example, it was written before credit cards, and micro loans were available in South Africa. The Usury Act was also very complicated and misunderstood by many.\(^4\)

In 1992 the first exemption notice was issued in terms of section 15A of the Usury Act.\(^5\) This notice exempted loans under ZAR6,000 from the provisions of the Usury Act and the interest rates that could be charged on these loans were uncapped. This gave birth to a large unregulated micro-lending industry.\(^6\) Low-income and poor consumers with no securable assets who could not access finance in the formal financial sector started to access finance here where interest rates and other costs of credit were high. Some lenders charged interest rates of 30 to 200+ per cent per month or even 360 per cent per year.\(^7\)

As the micro-lending industry did not have access to the National Payment System, like banks did, they therefore started to use extreme unregulated money collection procedures in an attempt to collect their payments from the consumers. Such procedures consisted of lenders taking and holding consumers’ bank cards and private identification numbers (PINs) and then drawing a monthly amount from the consumers’ bank accounts to service their loans. Sometimes they would give consumers only a small cash amount to enable them to pay for their normal living costs. However, they often left them with no money.

In 1999 the 1992 Exemption Notice was repealed and replaced by a new 1999 Exemption Notice\(^8\) which brought about a new dispensation for the micro-

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\(^3\) Hereafter ‘the Credit Agreements Act’.

\(^4\) See Hofmeyr, Herbstein and Gihwala Inc (R Willemse and N Mxunyelwa), ‘Report for the purposes of the credit law review’ (December 2002) in paras 4.1 and 6.7.


\(^6\) See Hofmeyr, Herbstein and Gihwala above n 4, in para 4.2.


lending industry. In terms of this Notice loans of up to ZAR10,000 which were payable in instalments of less than 36 months and not advanced by credit cards or overdrafts were exempted from the provisions of the Usury Act. However, micro-lenders had to comply with other conditions in order to qualify for the exemption. The most important was that micro-lenders had to register with a body called the Micro Finance Regulatory Council (hereafter ‘the MFRC’). The 1999 Exemption Notice thus attempted to regulate the micro-lending industry. However, this provided limited regulation, as the MFRC only had control of those lenders registered with it. The 1999 Exemption Notice (and the MFRC to a certain extent) also provided for limited disclosures to be made to the consumers, and provided for administrative penalties for non-compliance by registered micro-lenders. The practice of lenders to collect their money by way of keeping a consumer’s bank card and PIN was specifically abolished in the exemption notice. It was also later prohibited under the Usury Act. One loophole with the exemption notice was that lenders offered the same consumers various ZAR10,000 loans, which had the effect of lenders advancing large amounts of money outside the provisions of the Usury Act at very high interest rates.

Another act that governed consumer credit to a certain extent was the Credit Agreements Act. While the Credit Agreements Act was mainly concerned with the contractual aspects of credit agreements, the Usury Act aimed to regulate the financial aspects of the contracts. Although the Credit Agreements Act did not deal with money lending transactions as the Usury Act did, their scopes overlapped and anomalies between the two acts existed.

III. BACKGROUND TO THE NATIONAL CREDIT ACT

The South African financial sector has always been rather complicated, consisting of both a highly developed formal financial system (serving primarily middle- and high-income consumers (who are predominantly white) and large enterprises), serviced mainly by banks and other financial institutions, and an informal financial market (serving low-income consumers (about 85 per cent of the population—the majority of whom are the historically disadvantaged) and small and medium enterprises) serviced mainly by micro-lenders, loan sharks

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10 See GN R6959 Government Gazette 21893 of 13 December 2000. See, also, the comments by Hofmeyr, Herbstein and Gihwala, above n 4, in para 6.4.
11 See Hofmeyr, Herbstein and Gihwala, above n 4, in paras 4.2 and 5.2.
12 See Hofmeyr, Herbstein and Gihwala, above n 4, in para 5; and Bamu and Collier, above n 7, at 6.
Over the last couple of years the levels of overindebtedness in South Africa have increased dramatically. There were many reasons for this. It is common cause that since 1994 historically disadvantaged consumers, who never had access to credit, suddenly obtained such access. This went hand-in-hand with transformation in the civil service, affirmative action and aspirational borrowing. This lead to reckless lending and many found themselves overindebted or with no income. The number of administration orders that were granted also rocketed and it became an industry in itself.16 Another reason for the high level of overindebtedness seemed to be that a large portion of the historically disadvantaged consumers (that is, the majority of the population) were still excluded from the formal financial market, which forced them to access their finance (particularly credit) through the informal financial market (for example, micro-lenders and loan sharks) where credit was expensive. They were often (and still are) considered to be high risk and generally do not possess any assets which could serve as security for their loans. These consumers were (and still are) therefore forced to access finance through the informal sector where interest rates and other costs of credit are high and legal regulation is often non-existent.

It also became apparent that a dysfunctional credit market existed which was inter alia based on the following problems in the consumer credit market:17

13 This is derived from the Zulu/Xhosa word 'ukuchona', which means 'to be broke or poor', and the title 'Umachonisa' means 'the one who impoverishes others'. The plural form is 'bomachonisa'. A Umachonisa is an individual that acts as a loan shark in African communities, especially townships. Advertising as an Umachonisa is done by way of referral to others in the family and the community. Due to the illegality of their activities, they only deal with family members and individuals with whom they are acquainted. This usually gives them assurance that they will not be reported to the authorities and they can also assess their debtors’ creditworthiness and financial standing. Normally they will only act with strangers if there are intermediaries who are known to them and who are willing to act as sureties for these loans. Loan agreements are concluded orally and there are no receipts or other written evidence of the agreement between the parties. The parties usually agree as to when the repayment must be made and the loan period ranges between a few days and a month. Interest rates are high and normally range from 30 to 50 per cent for the period. Generally, the debtor has to repay the loan and the interest on a once-off basis (see Bamu and Collier, above n 7, at 14–16 and also in fn 128).


15 An indigenous type of informal credit-rotating association in which a group of persons enter into an agreement to contribute a fixed amount of money to a common pool on a weekly or monthly basis, or as frequently as the members may agree upon. For a full discussion of stokvels, see WG Schulze, ‘The Origin and Legal Nature of the Stokvel’ (Part 1) (1997) 9 South African Mercantile Law Journal 18; and (Part 2) (1997) 9 South African Mercantile Law Journal 153.

16 See Hofmeyr, Herbstein and Gihwala, above n 4, in para 6.5.1. See also the discussion of administration orders below in para VII(A).

17 See, DTI, Credit Law Review: Setting the Scene (Pretoria, February 2004) 1. See also the research referred to below in n 20.
• fragmented and outdated consumer credit legislation (including the debt collection procedures in the Magistrates’ Courts Act 32 of 1944);\textsuperscript{18}
• ineffective consumer protection, particularly in relation to the 85 per cent of the population in low-income groups;
• high cost of credit and, for some areas, lack of access to credit;
• lack of or selective disclosure regarding credit towards consumers;
• exploitation of consumers by micro-lenders, intermediaries, debt administrators, and debt collectors (e.g., bank cards and PINs were still being kept by certain micro-lenders);
• credit providers behaved recklessly towards consumers when granting credit;
• lenders totally disregarded a consumer’s ability to repay leading to high levels of indebtedness;
• there was excessive soliciting/harassing for credit by various credit providers; and
• credit bureaux were not regulated and they often contained faulty and incorrect credit information.

The credit market that had developed was clearly inappropriate for the present and future political, economic and social context of South Africa. It was also a market that was characterised by discrimination, a lack of transparency, limited competition, high costs of credit and limited consumer protection. The mechanisms to prevent overindebtedness that were in place at the time could also not adequately promote the rehabilitation of consumers, and the available debt relief could also not assist already overindebted consumers to deal with their debt. A review of these mechanisms was therefore necessary. These various factors and the increasing use of credit by low-income consumers created an urgent need for a closer examination of the previous credit legislation and the credit market in general.\textsuperscript{19}

The Department of Trade and Industry (hereafter ‘the DTI’) decided, therefore, in 2001 to review South African credit legislation and to investigate the problems that were experienced in the credit market. In March 2002, the DTI set up a Technical Committee to undertake a review of consumer credit policy and legislation and to supervise all the relevant research and to obtain the necessary expert opinions.\textsuperscript{20} The review was co-ordinated by the MFRC.

\textsuperscript{18} See the market research that was conducted by Rudo Research and Training (see above n 7). Hereafter the Magistrates’ Courts Act 32 of 1944 will be referred to as ‘the Magistrates’ Courts Act’.
\textsuperscript{20} The following research reports were prepared for the DTI: P Hawkins The Cost, Volume and Allocation of Consumer Credit in South Africa FEASibility (Pty) Ltd (March 2003); Reality Research Africa Credit Contract Disclosure and Associated Factors: Executive Summary of Research to Determine Public Awareness of Legal Provisions in Relation to Credit and Satisfaction with Provisions for their Benefit (December 2002); and Rudo Research and Training, above n 7. The following expert opinions were obtained: Dymski, above n 7; Hofmeyr, Herbststein and Gihwala, above n 4; M Kunene (Legal advisor of the MFRC), ‘A Comparison of Consumer Credit Statutes’ (2002); and P Meagher (IRIS Centre, University of Maryland, United States of America) ‘Regulation of Payday Lenders in the United States’ (2002).
Credit market weaknesses identified by the Technical Committee included:  

- inadequate rules on the disclosure of the cost of credit, with the result that the cost of credit is regularly inflated above the disclosed interest rate, through the inclusion of a variety of fees and charges. This undermines the consumer’s ability to make informed choices, whether between cash and credit purchases or between different credit providers. It results in reduced consumer pressure on credit providers to reduce interest rates;

- an unrealistically low Usury Act cap causes low income and high-risk clients to be marginalised;

- weak and incomplete credit bureau information results in bad client selection, ineffectual credit risk management and high bad debts, resulting huge increases in cost of credit;

- inappropriate debt collection and personal insolvency legislation creates an incentive for reckless credit provision and prevents effective rehabilitation of overindebted consumers;

- excessive predatory behaviour leads to high levels of debt for certain consumers and unmanageable risk to all credit providers; and

- inconsistencies in legislation related to mortgages and property transfers undermine consumers’ ability to offer security and locks them into high cost, unsecured credit.

Although it was impossible to trace the cause of the high cost of finance (and limited access) to any single factor, the combination of factors identified appear to go a long way in explaining the problem.

The Credit Law Committee took stock of the existing consumer credit legislation and also researched consumer credit reforms in Europe and certain other countries. Furthermore, it consulted widely with various stakeholders and concluded that both the Usury Act (including the 1999 Exemption Notice) and the Credit Agreement Act should be replaced by a single act, overseen by a statutory regulator. A main proposal was that the focus should be shifted from price control to protection against overindebtedness, and to the regulation of undesirable lending practices. Furthermore, special attention should also be given to the disclosure of credit related fees and charges. The DTI also followed up the Technical Committee’s findings and recommendations with a Policy Framework for Consumer Credit.

The in-depth review of credit legislation initiated by the DTI eventually resulted in the promulgation of the National Credit Act 34 of 2005 and the

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21 See DTI, Credit Law Review: Summary of Findings of the Technical Committee (August 2003); DTI, Credit Law Review, above n 17; and the research reports referred to above in n 20.

22 See Goodwin-Groen, above n 14, at 14.


24 Published in Government Gazette 28619 of 15 March 2006 (hereafter I will refer to the National Credit Act 34 of 2005 as the ‘NCA’).
National Credit Regulations\textsuperscript{25} in 2006. The NCA repealed and replaced the Credit Agreements Act and Usury Act.

The Credit Law Review Committee supervised all the research and expert opinions\textsuperscript{26} that were undertaken before the NCA was drafted and they also developed the initial policy proposals.\textsuperscript{27} The Credit Law Review was also influenced by credit law reform in the United Kingdom, the European Commission and New Zealand.\textsuperscript{28} The DTI took the Committee’s proposals and developed them into a ‘Policy Paper’ which formed the basis upon which the NCA was drafted.\textsuperscript{29} Mr Gabriel Davel, the Chief Executive Officer of the MFRC, was the ‘policy advisor’ to the NCA and he ensured that the wording of the NCA reflected the DTI’s policy objectives. The DTI also appointed the MFRC as its representative to assist with the physical drafting of the NCA.\textsuperscript{30}

IV. OBJECTIVES AND APPLICATION OF THE ACT

The NCA’s overarching purpose is to create a single system of credit regulation and a National Credit Regulator to administer the credit industry. It seeks to promote the social and economic welfare of South Africans, and a fair, transparent, competitive, efficient and accessible credit market for all, particularly those who have historically been unable to access credit under sustainable market conditions. It also prohibits unfair credit and credit marketing practices and protects consumers of credit. A further objective is to encourage responsible borrowing, avoidance of overindebtedness and reckless lending, and to provide for a consistent and harmonised system of debt restructuring, enforcement and judgement.\textsuperscript{31}

The Act applies, subject to certain exemptions, to all credit agreements\textsuperscript{32} (for example, money-lending transactions irrespective of the amount) between parties dealing at arm’s length and made within, or having an effect within South

\textsuperscript{25} Published in \textit{Government Gazette} 28864 of 31 May 2006, \textit{Regulation Gazette} No 8477, R489 (hereafter ‘the Regulations’).
\textsuperscript{26} See above n 20.
\textsuperscript{28} See the memorandum to the National Credit Bill 18 of 2005 (as it was then).
\textsuperscript{30} The main drafter of the NCA was the Canadian legislative drafter, Prof Phil Knight. Prof M Kelly-Louw from the University of South Africa provided expert legal advice during the drafting process of the NCA and she also drafted the consequential amendments contained in Schedule 2 of the NCA. The drafting team of the NCA also consulted broadly with various key players and interest groups and associations during the drafting process. The State Law Advisors also played a vital role in approving and signing off on the NCA. Parliament also held various public hearings regarding the National Credit Bill before it was finalised as an act.
\textsuperscript{31} See the preamble to the NCA and s 3.
\textsuperscript{32} Credit agreements include any credit facility, credit transaction, credit guarantee, or any combination of the aforesaid. For a full definition of ‘credit agreement’, see s 8.
Africa. The NCA applies mainly to situations where the consumer (borrower/debtor) of a credit agreement is an individual (that is, a natural person).

V. CONSUMER CREDIT INSTITUTIONS

On 1 June 2006 the NCA established a National Credit Regulator (NCR), who is responsible for the regulation of the South African credit industry. The NCR is tasked with carrying out education, research, policy development, registration of industry participants, investigation of complaints, and ensuring enforcement of the Act. The NCR is required to promote the development of an accessible credit market, particularly to address the needs of historically disadvantaged persons, low-income persons, and remote, isolated or low-density communities. Furthermore, the NCR is also tasked with the registration of credit providers, credit bureaux and debt counsellors; cancellation or suspension of the registration of credit providers, credit bureaux and debt counsellors; dealing with complaints; promoting alternative dispute resolution; and enforcement of compliance with the Act. As most type of credit providers (for example, financial institutions, micro-lenders, and retailers) have to register with the Regulator, a failure to register as a credit provider may lead to the credit agreements of the particular credit provider being regarded as null and void. Provision is also made for Provincial Credit Regulators to be created later and to fulfil similar functions.

The NCA also establishes a National Consumer Tribunal. The Tribunal is an independent body, separate from the NCR, with members appointed by the President. The Act provides for limited circumstances where applications can be made directly to the Tribunal by consumers, credit providers, credit bureaux and debt counsellors. Direct applications can only be made if the parties have failed to resolve the matter directly between themselves and alternative dispute resolution has failed. Referrals of prohibited practices generally can be made to the Tribunal by the NCR. In certain circumstances, where the NCR decided not

33 See s 4.
34 However, where the consumer is a company, close corporation, partnership, or a certain type of trust and its asset value or annual turnover, at the time the agreement is made, does not equal or exceed a certain prescribed amount, the NCA will have limited application (see s 4 read with s 6).
36 See ss 12–25.
37 See s 40(1) of the NCA read with General Notice 713 in Government Gazette 28893 of 1 June 2006, which provide when it is compulsory for credit providers to register.
38 See ss 39–52. Registered industry participants also have to pay the necessary registration fees (initial and annual renewal) and also submit various reports, including compliance reports, regularly to the NCR (see, eg, GN R949 in Government Gazette 29245 of 21 September 2006, and ss 52(6), 70(5) of the NCA, and chapter 8 (Regs 62–71) of the Regulations).
39 See ss 54–59.
40 See, eg, ss 1, 14(c)(i), 37, 38, and item 9 of schedule 3.
42 For a list of when applications may be made to the Tribunal, see s 137.
to refer a matter, a direct referral can be made to the Tribunal by the complainant. The Tribunal is responsible for hearing cases against credit providers which have contravened the NCA. The Tribunal is also empowered to issue fines where it is deemed necessary. In addition to its powers to adjudicate disputes directly, the Tribunal also has the authority to make a consent order reflecting any resolution arrived at through an alternative forum and/or issue a compliance notice. Credit providers and consumers may also appeal to the Tribunal against decisions of the NCR. Parties can also appeal against decisions made by the Tribunal or may apply to a High Court to review such decisions.

VI. PREVENTION OF OVERINDEBTEDNESS

A. Consumer Education

Section 3(e)(i) of the NCA provides that one of the purposes of the Act is to protect consumers, by addressing and correcting imbalances in negotiating power between consumers and credit providers by providing consumers with education about credit and consumer rights. The NCR is responsible for increasing knowledge of the nature and dynamics of the consumer credit industry, and for promoting public awareness of consumer credit matters, by implementing education and information measures to develop public awareness of the provisions of the NCA. Thus, the duty of educating the consumers about credit has been bestowed upon the NCR. Since the establishment of the NCR, the Regulator has been actively involved in educating consumers and credit providers. Since the Act came into operation some of the major banks have also tried to educate consumers by placing certain vital information regarding the new NCA on their respective websites.

Various stakeholders feel that educating and empowering consumers are vital as this will enable consumers to have knowledge of and take responsibility for their credit matters as well as encourage them to read before signing any contracts related to credit. According to them, there is a definite need for financial education and it should start at school level and be included in the South African school curriculum. Finances are viewed as a life skill, just like sex and HIV/AIDS education, and it would help children to have a relationship with money at an early age. Therefore, financial education should form part of the subject called ‘life skills’ currently taught at schools.

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43 See s 138.
44 Section 16(1)(a).
45 For details of the consumer education that has been done and a list of the awareness activities, see the NCR’s Annual Report (2007) at 19–22 (obtainable at <http://www.ncr.org.za> accessed 13 January 2008).
47 Rudo Research and Training above n 7, at 9–10.
B. Prohibition of Certain Credit Marketing/Advertising Practices

Research has indicated that unsolicited credit offers cause consumers to take on more debt than they believe they should. Particularly at risk are first-time credit users and middle-income consumers who may be living beyond their means. For instance, it has been found that misleading advertising, unsolicited mail offerings for loans and credit, coercive sales techniques, aggressive agents and brokers, ever increasing credit card limits and increasing limits on store cards each play a role.48

The NCA contains several limiting and prescriptive provisions regarding various aspects of credit marketing and advertising practices.49 First, credit agreements cannot be marketed on the basis that an agreement will automatically come into existence unless the consumer declines the offer. Second, any solicitation by a credit provider for the purpose of inducing a person to apply for credit must include a statement with prescribed information depending on the particular type of solicitation. Third, soliciting of credit (excluding developmental credit)50 at the home or work address of a consumer is generally prohibited, unless the consumer specifically invited the credit provider to such address for that purpose.51 Finally, advertising and marketing practices are regulated.52 For example, when a credit provider advertises, he must avoid any small print—there are prescriptions as to the size and position of special conditions in an advertisement for credit.

C. Disclosure

In the past, as already mentioned, there were only selective disclosures (basically only the interest rate was disclosed) made by credit providers. Furthermore, consumers often did not receive a copy of their credit agreement before conclusion of the contract, and contracts were often rather lengthy, often leaving consumers with no time to read through the contracts before signing them. The language used in contracts was also often too difficult for average consumers to understand and consumers only realised the full impact of the credit agreement when they received their first account. They also often felt cheated as it was

49 See ss 74–77.
50 Developmental credit is defined in s 10.
51 See s 75.
52 See s 76. Regs 21 and 22 also stipulate the exact information that a credit provider needs to display in certain advertisements when offering to supply credit (eg, when an advertisement is placed for a specific credit product). Provision is also made for the exact form the required information needs to be in.
often not disclosed to them when they signed their credit agreements whether
the interest was charged on a monthly or an annual basis.53

The NCA regulates the disclosures that are required before an agreement may
be concluded, the form or format in which the agreement must be, and the can-
cellation, rescission and alteration of a credit agreement. It also specifically
states that credit agreements must now be in plain and understandable lan-
guage54 and it is hoped that this will assist consumers with a better understand-
ing of their credit agreements. Consumers also have the right to receive any
document and information in one of the 11 official languages of South Africa.55

A credit provider must supply a consumer with a pre-agreement disclosure
statement that includes the main features of the proposed agreement and a cost
quotation of the credit, which is binding on the credit provider for five days after
the presentation of the quotation. Where the agreement is a small credit agree-
ment56 (for example, a credit card where the credit limit is below ZAR15,000),
the credit provider must give the consumer a pre-agreement statement and a
quotation in the prescribed form. Where the agreement is a large or intermedia-
te agreement,57 the credit provider must give the consumer a pre-agreement
statement in the format of the proposed agreement or in another form, address-
ing the matters prescribed by the Act and a quotation in the prescribed form (for
example, setting out the principal debt, interest rate and other credit costs (that
is, the total cost of the credit)).58 All contracts must comply with the prescribed
formalities in the regulations.

The NCA requires comprehensive disclosure of all interest and other fees and
charges (for example, initiation and service fees) payable on the principal debt
as a percentage and Rand value together with a repayment schedule in the form
of a pre-agreement statement and quotation so that the client has time to reflect
before committing to the loan.59

The credit provider must also deliver to the consumer, without charge, a copy
of a document that records their credit agreement. It must be transmitted to the
consumer in a paper form, or in a printable electronic form.

Today, full disclosure of all the costs of credit must be made by credit
providers. Credit providers who do not comply with the disclosure provisions
of the Act risk an administrative fine of either ZAR1,000,000 or 10 per cent of

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53 See the empirical research conducted by Reality Research Africa that explored consumer per-
ceptions in respect of consumer credit and the process of buying on credit. (For a full discussion
hereof, see Reality Research Africa, above n 20.)

54 See s 64.

55 See s 63(1).

56 For a definition of a small credit agreement see s 9 of the NCA; and see also GN 713 in
Government Gazette 28893 of 1 June 2006.

57 For definitions of an intermediate or large credit agreement see s 9 of the NCA; and see also
GN 713 in Government Gazette 28893 of 1 June 2006.

58 The maximum rates of interest, fees and charges that may be charged on credit agreements are
set out in the NCA and the Regulations.

59 See s 92 of the NCA read with Regs 28 and 29.
their annual turnover during the preceding financial year, whichever is the greatest.⁶⁰

D. Making Credit More Affordable: Capped Costs of Credit and the Statutory in Duplum rule

Rudo Research and Training was mandated by the DTI during the credit reviewing process to conduct market research regarding the perceived weaknesses in the previous credit legislation. The main aim was to elicit views on how to address these weaknesses to protect consumers in credit and micro/personal loan transactions as part of the credit law review. The 42 respondents who took part included representatives from credit providers, consumer organisations, trade unions, consumers and legal academics.⁶¹ The respondents from all the different areas all agreed that interest rates had to be regulated and that this had to be done by way of creating clear interest rate formulas.⁶²

In other research, which was also mandated by the DTI, the cost, volume and allocation of consumer credit in South Africa during 2003 was studied.⁶³ It was found that although the repealed Usury Act with its legislated lending rate ceiling aimed to protect consumers, it was evident that in many market segments, providers use the cap as if it were a prescribed rate. Furthermore, despite the existence of the usury cap that existed under the now repealed Usury Act, the costs of credit for consumers in various market segments exceeded the usury cap rate. Even where there was compliance with the usury cap, the cost of credit was inflated by a number of additional charges (for example, transaction and administrative fees) over and above the finance charge.⁶⁴

It was decided to maintain the status quo and continue to cap interest rates. However, in an attempt to make credit more affordable for consumers it was also decided that the NCA and its Regulations would not only place strict caps on interest rates, but also on other costs of credit (that is, non-interest costs) such as initiation fees and service fees. For the first time caps have now also been placed on initiation fees and service fees.

The NCA is prescriptive as to the type of fees or charges that a credit provider may charge a consumer.⁶⁵ A credit agreement must not require payment by the consumer of any money or other consideration except the principal debt, an initiation fee, service fees, interest, cost of credit insurance, default administration charges and collection costs. The NCA stipulates that there are certain maxi-

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⁶⁰ See s 151.
⁶¹ Rudo Research and Training, above n 7. A full list of all the respondents that took part is found in the addendum at 43.
⁶² Rudo Research and Training, above n 7, at 2 and 42.
⁶³ See Hawkins, above n 20. A list of the individuals (mostly representatives of credit providers) interviewed or consulted in production of this report is found at 69–71.
⁶⁴ See Hawkins, above n 20, at 1–2.
⁶⁵ See ss 100–106.
mums for interest and other costs of credit that may be charged on credit agreements.\(^{66}\) The Regulations\(^{67}\) are complementary to the Act and specifically provide for the maximum allowable interest rates\(^{68}\) and other costs of credit (service fees\(^{69}\) and initiation fees\(^{70}\)) that may be charged on credit agreements. The maximum ‘interest rate’ which can be charged for a credit agreement is calculated according to a formula where RR is the reference rate, being the ruling South African Reserve Bank Repurchase Rate, as at the time that the credit agreement is entered into. There are seven different types of credit (for example, mortgage agreements, credit facilities, development credit agreements) to which different maximum interest rates\(^{71}\) and initiation fees apply.\(^{72}\) The different interest rates that apply to the different type of credit are rather complicated to understand and it is unlikely that the average consumer will be able to understand it. For instance, the maximum interest rate that can be charged for an unsecured loan is the SA RR (currently 11 per cent)\(^{73}\) × 2.2 + 20 per cent per annum (= 44.2 per cent) and then plus the initiation fee (ZAR150 per credit agreement, plus 10 per cent of the amount of the agreement in excess of ZAR1,000, but never to exceed ZAR1,000)\(^{74}\) and the service fees (a maximum of ZAR50 per month) may still be added.

The NCA also codified the common law in duplum rule.\(^{75}\) The common law in duplum rule provides that interest stops running when unpaid interest is equal to the outstanding capital amount. If the total amount of unpaid interest has accrued to an amount equal to the outstanding capital sum, the defaulting debtor must first start making payments on his loan again (and so decrease the interest amount), after which interest may once again accrue to an amount equal to the outstanding capital sum. The rule thus effectively prevents unpaid interest from accruing further once it reaches the unpaid capital sum. The in duplum rule is based on public policy, as its purpose is to protect a debtor who is in financial difficulty and is unable to service his debts, from an ever-increasing accumulation of interest.\(^{76}\)

\(^{66}\) See ss 100–106.

\(^{67}\) See Regs 39–48.

\(^{68}\) See Reg 42(1).

\(^{69}\) See Reg 44.

\(^{70}\) See Reg 42(2).

\(^{71}\) See Reg 42(1).

\(^{72}\) See Reg 42(2).


\(^{74}\) An initiation fee may also never exceed 15 per cent of the principal debt—see Reg 43(3).

\(^{75}\) Section 103(5) contains the statutory rule and it provides as follows:

‘Despite any provision of the common law or a credit agreement to the contrary, the amounts contemplated in section 101(1)\((b)\) to \((g)\) [ie, initiation fees, service fees, interest, costs of any credit insurance, default administration charges, and collection costs] that accrue during the time that a consumer is in default under the credit agreement may not, in aggregate, exceed the unpaid balance of the principal debt under that credit agreement as at the time that the defaults occurs.’ (Emphasis mine.)

In a research paper (prepared for FinMark Trust) that focused mainly on the potential impact of the NCA and its Regulations on access to all forms of financial services, special attention was also given to what the effect of the maximum prescribed interest rates and other costs of credit would be. Special attention was given to the position regarding interest rate caps and usury laws in France, Germany, Switzerland, the United Kingdom, the United States and South Africa. Reference was also made to work done in 2004 by the United Kingdom’s Department of Trade and Industry (hereafter the ‘UK DTI’). The UK DTI assessed the impact of interest rate caps on both access and the pricing of credit for low-income groups in the United States, the United Kingdom, France, and Germany. It found much lower observed credit use among low-income households in markets with ceilings and attributed this to constrained credit options rather than lack of demand. Reference was also made to research done independently, by the Consultative Group to Assist the Poor. They analysed the effects of interest rate controls in almost 40 developing and transition economies. They established that in developing economies with interest rate ceilings it was difficult or impossible for formal and semi-formal micro-lenders to cover their costs, driving them out of the market (or keeping them from entering in the first place). Evidence showed that competition was the single most effective way to reduce both microcredit costs and interest rates. In many competitive markets, efficiency has improved and microcredit interest rates have declined.

In the FinMark Trust’s research paper it was stated that international experience in both developed and developing financial systems showed that price controls were not an optimal mechanism for managing the problem of the high costs of credit. The opinion was expressed that the reckless lending and disclosure regulations, together with the transparency rulings of the NCR, should promote competition and bring rates down. Therefore, an early removal of the price controls was urged. So far, there has been no response to FinMark Trust’s recommendation.

E. Preventing Reckless Lending

The NCA prohibits a credit provider from entering into a reckless credit agreement with a prospective consumer and also penalises the credit provider that does enter into such reckless agreements. The concept of ‘reckless lending’ was, until the NCA came into effect on 1 June 2006, unknown to South Africa.

77 See Goodwin-Groen, above n 14, in particular at 9–10, 19–30, and 47–51.
78 United Kingdom’s Department of Trade and Industry, The Effect of Interest Rate Controls in Other Countries (Policy Paper) (August 2004).
80 See Goodwin-Groen, above n 14, at 9.
In anticipation of the reckless lending provisions coming into operation on 1 June 2007, financial institutions were soliciting credit on a huge scale from the general public, in order to avoid the effect of the provisions. Consumers were bombarded with invitations from financial institutions offering pre-approved credit cards and loans. Desperate consumers who already found themselves in financial difficulties often fell victim to these invitations, thereby increasing their levels of overindebtedness. However, since the NCA came into operation, these types of solicitation and conduct from credit providers are either no longer permitted or strictly regulated, and it is hoped that these provisions will prevent overindebtedness.

In order to assist a credit provider with determining whether a consumer is creditworthy, the NCA has incorporated and defined the concepts of ‘overindebtedness’ and ‘reckless lending’. The two key terms are defined as follows:

Credit is lent recklessly if:

- either the credit provider took no steps to assess the proposed consumer’s:
  - general understanding and appreciation of the risks and costs of the proposed credit agreement, and his rights and obligations under the agreement;
  - debt repayment history for credit agreements;
  - existing financial means, prospects and obligations\(^81\) (that is, assessment whether a consumer can make the repayments); and
  - whether there is a reasonable basis to conclude that any commercial purpose may prove to be successful, if the consumer has such a purpose for applying for the credit; or

- after having conducted such an assessment, the credit provider still entered into the credit agreement with the consumer despite the fact that the preponderance of information available to the credit provider indicated that:
  - the consumer did not generally understand or appreciate his risks, costs or obligations under the proposed credit agreement; or
  - entering into that credit agreement would make the consumer overindebted\(^82\).

\(^81\) Section 78(3) provides that ‘financial means, prospects and obligations’ in this context, with respect to a consumer or prospective consumer, includes the following:

  - income, or any right to receive income, regardless of the source, frequency or regularity of that income, other than income that the consumer or prospective consumer receives, has a right to receive, or holds in trust for another person; and
  - the financial means, prospects and obligations of any other adult person within the consumer’s immediate family or household, to the extent that the consumer, or prospective consumer, and that other person customarily share their respective financial means; and mutually bear their respective financial obligations; and
  - if the consumer has or had a commercial purpose for applying for or entering into a particular credit agreement, the reasonably estimated future revenue flow from that business purpose.

\(^82\) See s 80(1) read with s 81(2). Note, however, that the provisions of reckless lending do not apply to a school loan, student loan, and an emergency loan, provided the necessary information is reported to the NCR (see s 78(2) of the NCA, read with Reg 23).
Overindebtedness is defined as follows:83

A consumer is overindebted if the preponderance of available information at the time a determination is made indicates that the particular consumer is or will be unable to satisfy in a timely manner all the obligations under all the credit agreements to which the consumer is a party, having regard to that consumer’s:

• financial means, prospects and obligations; and

• probable propensity to satisfy in a timely manner all the obligations under all the credit agreements to which the consumer is a party, as indicated by the consumer’s history of debt repayment.’ (Emphasis added.)

If a debt counsellor84 has to decide whether a consumer is overindebted, he must take the aforesaid into consideration and must also consider whether a consumer’s total monthly debt payments exceed the balance derived by deducting his minimum living expenses from his net income. The counsellor must calculate the net income by deducting from the gross income of the consumer, statutory and other deductions that are made as a condition of employment. The minimum living expenses are based upon a budget supplied by the consumer, adjusted by the debt counsellor with reference to guidelines to be issued by the NCR.85

The NCA provides that whenever a credit agreement is being considered in any court proceedings, the court may declare that the credit agreement is reckless. If a court declares that a credit agreement is reckless, the court may make an order:

• setting aside all or part of the consumer’s obligations under that agreement, as the court determines is just and reasonable in the circumstances; or

• suspend the force and effect of that credit agreement,

and may then issue an order:

• suspending the force and effect of that credit agreement until a date determined by the court; and

• restructuring the consumer’s obligations under any other credit agreements, in accordance with the Act.86

The NCA also provides that, if a court declares that a credit agreement is reckless, because entering into the agreement made the consumer overindebted, the court:

• must further consider whether the consumer is overindebted at the time of these court proceedings; and

• if the court concludes that the consumer is overindebted, the court may make an order:

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83 See s 79(1).
84 See discussion of debt counsellors below in para VII(A).
85 See Reg 24(7).
86 See ss 83(1)—(2).
—suspending the force and effect of that credit agreement until a date determined by the court; and
—restructuring the consumer’s obligations under any other credit agreements, in accordance with the Act.  

However, before making such an order the court must consider the consumer’s current means and ability to pay his current financial obligations that existed at the time the agreement was made, and the expected date when any such obligation under a credit agreement will be fully satisfied, assuming the consumer makes all required payments in accordance with any proposed order.  

The NCA also sets out the effect of suspension of a credit agreement. It provides that during the period that a credit agreement is suspended, the consumer is not required to make any payment under the agreement; no interest, fee or other charge under the agreement may be charged to the consumer; and the credit provider’s rights under the agreement, or under any law in respect of that agreement, are unenforceable, despite any law to the contrary. Furthermore, the NCA also provides that after the suspension of a credit agreement has ended, all the respective rights and obligations of the credit provider and the consumer under that agreement are revived, and are fully enforceable except to the extent that a court may order otherwise.  

In order to prevent consumers from abusing the reckless lending provisions, section 81(1) requires that when a consumer applies for a credit agreement, and while that application is being considered by the credit provider, the prospective consumer must fully and truthfully answer any requests for information made by the credit provider while he (the credit provider) is assessing whether or not to grant the credit. Furthermore, section 81(4) provides that it is a complete defence to an allegation that a credit agreement is reckless if: the credit provider establishes that the consumer failed to fully and truthfully answer any requests for information made by the credit provider as part of the assessment required by section 81; and a court or the Tribunal determines that the consumer’s failure to do so materially affected the ability of the credit provider to make a proper assessment.  

It is clear that a consumer will not be able to benefit from the reckless lending provisions, if he does not disclose all his financial obligations when he concludes the credit agreement. If the consumer failed to disclose all the relevant information to the credit provider when he applied for the credit, that credit agreement will not be deemed to have been granted recklessly (provided of course that the credit provider did a proper assessment as required by the NCA).  

In an attempt to improve the ability of a credit provider to do an affordability assessment, provisions have been included in the NCA to improve and integrate
the credit information infrastructure. To assist credit providers with not granting credit recklessly, a National Credit Register of Credit Agreements (hereafter ‘the Register’) will be created which will contain all relevant credit information regarding consumers (see s 69). However, the Register will only become effective once it is created by the NCR and an independent auditor has ‘approved and confirmed’ that the Register will be able to receive and compile the required information. As soon as this Register is established, credit providers will be required to submit certain information (for example, the name of the consumer and his identity number, the credit limit under a credit facility, or the principal debt outstanding under a credit agreement and the amount of the monthly instalments payable thereunder) to the Register when they enter into new credit agreements or amend current credit agreements. They will also be expected to supply certain information regarding the credit agreements that were concluded before the Act came into operation. The creation of such a Register will have the advantage that credit providers will be able to obtain the necessary credit information regarding a consumer and it will minimise the risk of credit providers granting credit to already overindebted consumers or those that might become overindebted if more credit is allowed.

The regulation of credit bureaux by the NCR means that credit providers will be in a position to rely on more accurate credit information kept by credit bureaux. In the past, consumers were blacklisted without being notified and the information kept by credit bureaux were often incorrect. Regulations were also issued which aimed to ‘clean up’ the current credit records held by all the credit bureaux. It also provided that a consumer was entitled, for a certain period of time, to inspect any of his credit records free of charge, enabling him to check whether the existing credit records were correct.

VII. MECHANISMS FOR RESOLVING OVERINDEBTEDNESS

A Debt Counsellors, Debt Counselling and Debt Restructuring

There is a huge potential demand for debt counselling assistance and it is estimated that 300,000 consumers in South Africa find themselves in an extreme overindebted position, while a further million or more are potentially debt-stressed. It would thus appear that debt counselling has a very important role to play.

Until the NCA came into effect there was only one process, besides formal insolvency (sequestration), that overindebted consumers could make use of to alleviate their position. Under section 74 of the Magistrates’ Courts Act a debtor...
who is unable to pay his debts may apply for an administration order,\(^\text{94}\) provided that his debts do not exceed an amount of ZAR50,000. Where such an application is granted, the debtor must make regular payments to an administrator. The administrator is obliged to draw up a list of creditors and must pay them from the amounts received from the debtor.\(^\text{95}\) In this sense an administration order is a debt relief measure available to some debtors who find themselves in financial distress which affords them the opportunity to obtain a statutory rescheduling of debt sanctioned by a court order.

In practice, an administration order is in many instances a failure, since debtors do not maintain regular payments. Furthermore, even if debtors do maintain their regular payments most of the payments go into the pockets of the administrators as ‘fees’ and little is paid to creditors to reduce their debts.\(^\text{96}\) There are also no set minimum requirements that administrators need to comply with (for example, it is possible for a micro-lender to also act as an administrator) and nor is there any regulatory body governing administrators. Moreover, the procedure does not provide for a discharge of debts. An administration order only lapses once the costs of the administration and the listed creditors have been paid in full. In view of the fact that the Magistrates’ Court Act contains no provision for the repayment of the debt to take place within a fixed time-limit, many debtors remain in a debt-trap. The latter problem is compounded by the fact that so-called in futuro debts, that is debts that are payable by means of future instalments due in terms of an existing and enforceable contract, are excluded from the administration procedure (for example, payments under a mortgage bond or credit agreement instalments). In the end the procedure thus amounts to nothing more than a formal rescheduling of debt.\(^\text{97}\)

In 2005 it was estimated that approximately 650,000 people’s affairs were being handled by administrators and there were about 1,200 such administrators in operation. Based on the limit on the amount of the debt, the debtors involved are usually from the lower income group and ignorant of their rights and the obligations of the administrator. Notwithstanding the existence of the National Association of Administrators, the industry is largely unregulated and malpractices are widespread.\(^\text{98}\)

\(^{94}\) For a full discussion of administration orders and their shortfalls, see A Boraine, ‘Some Thoughts on the Reform of Administration Orders and Related Issues’ (2003) \textit{De Jure} 217; and A Boraine, ‘The Reform of Administration Orders Within a New Consumer Credit Framework’, paper delivered on 11 April 2007 at the International Association of Consumer Law’s 11th International Conference on Consumer Law held on 11–13 April 2007 in Cape Town, South Africa, hosted by the Centre for Business Law, University of South Africa.

\(^{95}\) It is important to point out that in futuro debts, including mortgage bonds and assets subject to credit agreements and other in futuro debts like micro-loans, are in principle excluded from the administration proceedings. Therefore, a debtor must still service these debts after the granting of the administration order.

\(^{96}\) Although there are regulations that try to regulate the fees to some extent, they are often interpreted incorrectly.

\(^{97}\) See Boraine, above n 94.

\(^{98}\) See Bamu and Collier, above n 7, at 7.
Problems experienced in practice with administration orders have prompted the Department of Justice to implement a reform project. This also led to the South African Law Reform Commission appointing a Project Committee during 2003 to make formal proposals regarding the reform of administration orders. However, as the debt restructuring orders and debt counselling provided for in the NCA and its regulations will have an effect on administration orders, the Project Committee has decided to place its reform on hold until the full force of these sections and regulations of the Act is experienced in the market.99

The NCA now provides for another alternative to a sequestration order which will be available to overindebted consumers. It provides for debt re-organisation/restructuring and debt counselling in cases of overindebtedness and for the registration of debt counsellors with the NCR. Provision is made for a consumer to directly apply to a debt counsellor for a review of his debt or to a court so that it can refer the matter to a debt counsellor (debt counsellors are thus either appointed by overindebted consumers or courts). The debt counsellor must determine whether any credit agreement concluded by the consumer is reckless and make the appropriate recommendation to a relevant court. Debt restructuring orders are similar to the current administration orders being issued.

In order to become a debt counsellor, a natural person must register with the NCR and must inter alia comply with certain minimum requirements.100

Any natural person irrespective of the amount of debts owed under all his credit agreements may apply for a debt restructuring order. As the application of the administration order relates to limited debts, it is thus possible that the same consumer might be subjected to an administration order as well as a debt restructuring order.

However, debt restructuring orders will only be effective if all the pitfalls and problems experienced with administration orders are properly addressed and corrected.

B. Debt Collection Procedure Changed

The NCA has also drastically changed our traditional legal debt collection procedures.101 There is now a new prescribed procedure that a credit provider must follow when he wants to collect the debt from a defaulting consumer, and before legal action may be instituted in a court of law. For instance, section 129 of the NCA provides that a letter of demand sent to a defaulting debtor must draw the debtor’s attention to the fact that he has a right to use various alternative dispute resolution mechanisms (for example, he may ask for the assistance

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99 See Boraine, above n 94.
100 See s 46 and Reg 10.
101 See ss 127–133.
of a debt counsellor), before the credit provider may institute legal court pro-
ceedings.

The NCA also promotes the use of ombudsmen, and other alternative dispute
agencies on the basis of prescribed standards. Parties to credit agreements are
couraged to seek resolution of disputes through mediation, conciliation or
arbitration through either provincial consumer courts, ombuds or other such
agencies before resorting to courts.102

VIII. IMPACT OF THE ACT ON ORDINARY SOUTH AFRICANS

A recent survey was conducted to assess the impact of the NCA on ordinary
South Africans.103 Telephone interviews were held with 676 people in the major
metropolitan areas of South Africa (Johannesburg, Cape Town and Durban) to
investigate perceptions of the NCA.104 One hundred and seventy-seven of the
respondents to the survey had never heard of the NCA. The remaining 499
respondents had heard of the NCA (and they completed the entire survey) and
41 per cent of them believed they had been personally affected by the new NCA.
The highest proportion of those who stated that they had been affected by the
NCA were males, as well as respondents in the 20–24-year age group. The
authors of the study concluded that this was ‘very possibly due to the high
amount of credit application that takes place during this lifestage and the fact
that in South Africa males are still the primary “financiers” for their families’.
Most respondents had applied for vehicle and asset finance, a home, personal,
or study loan. Very few had applied for store cards or accounts. Only 44 per cent
of the respondents stated that their banks had communicated with them about
the NCA.

Respondents were asked what kind of impact they thought the NCA would
have on local industry as well as the overall economy. One third stated that they
believed that the NCA would have a positive effect on local industry, while 37
per cent believed that the Act was good for the overall economy. From this it
seems that there is a substantial degree of public support for the NCA. When
asked about how the credit application process had changed, 34 per cent who
had applied for credit described the process as ‘very simple’. The authors of the
study stressed that the reason for this was possibly due the fact that, when
applying for vehicle finance or even a home loan, very often the finance and
insurance department of the bank or even the mortgage originator would take
care of a consumer’s application and he would have very little to do until his sig-

102 See ss 134–135.


104 See ‘Kredietwet steek nie stokkie voor aanbiedings per pos of foon’, Sake Rapport of
The introduction of appropriate mechanisms to prevent and penalise reckless lending in the NCA should have the effect of reducing further credit being offered to consumers who are already overindebted. It is also hoped that the debt relief provided for in the NCA will assist those who are already unable to repay their debts.

The NCR has stated in its 2007 Annual Report that the effectiveness of the NCA will depend on credit providers accepting the principles and objectives that the Act is attempting to achieve, and co-operating in its implementation. ‘It is in the engagement of consumers with credit providers, credit bureaux and debt counsellors that the Act will become a reality in people’s lives.’ Of course, the success of the Act will also depend on the NCR’s ability to effectively police and enforce it.

There is already evidence indicating that the NCR will vigorously and actively enforce the provisions of the Act. For example, due to a number of

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105 See the NCR’s Annual Report, above n 45 at 9.
complaints received from the public, the NCR started to investigate the business practice of Rudco Finance (Pty) Ltd, a large micro-lender. The investigation revealed that Rudco contravened a number of provisions of the NCA. For instance, Rudco required consumers to make loan repayments and make payments in respect of monthly service fees, prior to the loans having been advanced; and charged monthly service fees in excess of the prescribed maximum rate allowed. Rudco was ordered not to continue with these illegal practices and to also reimburse about 1,800 consumers for amounts received in contravention of the NCA, totalling approximately ZAR7 million. In the end Rudco failed to make the necessary repayments and was placed under final liquidation, based on the NCR’s application. In another matter, the NCR served TransUnion Credit Bureau with a Compliance Notice following the latter’s failure to comply with certain regulations relating to data cleansing in terms of the NCA. Recently, it also came to the knowledge of the NCR that certain credit providers were still retaining borrowers’ bank cards and therefore it issued Compliance Notices to 14 credit providers for contravening the relevant provisions of the NCA. These credit providers were ordered to immediately return all bank cards and pension cards to the relevant borrowers and they also had to destroy all records of PINs and automatic teller access information in their possession.
The Myth of the Cautious Consumer: Law, Culture, Economics and Politics in the Rise and Partial Fall of Unsecured Lending in Japan*

SOUCHIROU KOZUKA AND LUKE NOTTAGE

I. THE RISE AND PARTIAL FALL OF UNSECURED CONSUMER LENDING IN JAPAN

From mid-2007, widespread concern in the US about overly risky home mortgage lending led to the collapse of major hedge funds and turmoil in various financial markets. In Australia, media and political attention also focused on problems with home lending, as well as unsecured consumer loans particularly through credit cards. Less well reported has been a similar upheaval in Japanese financial markets triggered by tighter control asserted since 2006 over burgeoning unsecured consumer loans, albeit typically extended in the form of cash advances. This Chapter begins by summarising the growth and recent contraction of this market.¹ Both aspects challenge some still-common conceptions about Japanese behaviour. The rise suggests that the Japanese are not particularly frugal or careful in their borrowing behaviour. The partial fall suggests that they are not always averse to asserting rights through the courts or to creating new ones through the legislative process, even as consumers.

Part II therefore critically examines three major theoretical paradigms conventionally advanced to explain the relationship between law and socio-economic context in Japan. Part III concludes that some revamped cultural and economic explanations do help to understand the growth in consumer credit,


but a *political* theory of ‘less patterned pluralism’ provides the best explanation for the recent re-regulation. This analysis is important for those seeking to understand what drives similar developments in many other countries. It also provides a platform for advancing more normative debates about what should be done to address the persistent world-wide problem of consumer overindebtedness through unsecured lending.2

Since the 1980s, Japan’s overall consumer debt increased to levels comparable to or even higher than other major industrialised economies.3 Over the 1990s, the proportion of ‘sales credit’ (*hanbai shinyo*, associated with purchases of specific goods) grew. There was a corresponding decline in pure ‘consumer credit’ (*shobisha kinyu*), but the make-up shifted from secured loans (10 trillion yen in 2004) to unsecured loans (*shobisha roon*, 24 trillion yen), especially those provided by non-bank ‘consumer credit companies’ (*shobisha kinyu gaisha*: 10 trillion yen) as opposed to banks.4 Around 3 million out of 14 million borrowers of unsecured loans were considered overindebted in 2006.5 This underpinned record consumer bankruptcies, debt-related suicides, and increasing concern about aggressive marketing as well as debt enforcement tactics.

Almost all this growth in unsecured lending has occurred through cash advances, rather than credit cards as in countries like Australia, the UK and especially the US. This difference was due to Japan being a smaller country with a more unified banking system, yet segmented financial markets (with banks focusing on secured or corporate lending); more limited sharing of ‘positive information’ (consumers’ good history regarding credit limits and repayments); and higher telecommunications charges, at least over the 1990s. Further, even after gradual deregulation of banks issuing credit cards as a lending mechanism between 1982 and 2001, they set the default rule as monthly repayment in full (*ikkai barai*). Banks were also cautious about the reputational implications of moving into the unsecured lending market, traditionally characterised by high interest rates and aggressive debt collection practices.6 Consumers probably had similar concerns, although they have slowly become more familiar with consumer credit companies. Greater use of cash for payments may also have contributed to Japan’s preference for cash advances.

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Such unsecured consumer lending expanded rapidly, however, for rather similar reasons. These included macro-economic slowdowns; automation and IT (particularly the deployment of automated loan-dispenser machines from 1993); and clever advertising campaigns (promoting a ‘safe’ image particularly for stressed-out ‘salarymen’ with regular employment in companies, and then increasingly targeting younger low-income earners). Japan’s consumer lenders also developed new business models similar to those found in the US. There are strong parallels both with the ‘sweat box’ model of credit card companies (aiming to keep borrowers endlessly paying off interest but not the principal)\(^7\) and the practices associated with ‘payday lending’ in the US,\(^8\) especially techniques encouraging borrowers to take out further loans with the same or other even less reputable lenders in order to pay off interest on the initial loans. Indeed, among Japan’s top lenders, GE Money developed the ‘Lake’ network from 1994 (but decided to sell it in 2008), and Citigroup took over ‘DIC’ from 2000.

Japan’s expansion of consumer lending occurred in a substantially unregulated and fragmented market. ‘Sales credit’ was governed largely by the Instalment Sales Law (No 159 of 1961) under the jurisdiction of what is now the Ministry of the Economy, Trade and Industry (METI), responsible for industrial policy. Other credit was regulated primarily through interest rate and other restrictions under the Interest Rate Restriction Law (IRRL, No 100 of 1954; but with a precursor dating back to the Meiji Era, Ordinance No 66 of 1877) and the Capital Funding Law (Law on Investments, Deposit Taking and Other Financial Transactions, No 195 of 1954: the *Shusshi Ho*). The main regulator has been the Ministry of Finance (MoF), now the Financial Supervisory Agency (FSA), but local governments were also involved in registering consumer credit companies.

Although Japan seems to have deployed most of the techniques for addressing consumer loan problems,\(^9\) a major focus of legislation and case law has been interest rate control. As specialised private law, the IRRL set a cap of 15–20 per cent (depending on loan amount), but excess interest paid ‘voluntarily’ by the borrower could not be reclaimed. As criminal law, the *Shusshi Ho* set penalties for interest charged at more than 29.2 per cent (since 2000). This created a ‘grey zone’ gap between the two legislated rates. In the 1960s, an era of broader consumer activism,\(^10\) Japan’s (highest) Supreme Court favoured borrowers by rejecting a literal reading of the IRRL. The Court allowed grey zone interest to be converted into principal repayment, and later allowed recovery of the

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difference between the excess interest paid and the principal. This prompted the Moneylenders Control Law (Kashikingyo Kiseiho, No 32 of 1983) to allow lenders to keep the grey zone interest after all. The Supreme Court upheld this on 22 January 1990 (44 Minshu 332). From the late 1990s, however, it developed both literalist and purposive interpretations of that Law to favour borrowers again. Several judgments held that disclosure and procedural requirements had not been adequately followed. The final nail in the lenders’ coffin came on 13 January 2006 (60 Minshu 1), when the Court ruled that an acceleration clause in the loan agreement put so much pressure on the borrower that its grey zone interest payments were not ‘voluntary’.

Legislation therefore ultimately proved more effective reining in very high interest rates, as opposed to the other two out of ‘three evils’ characterising consumer lending in Japan (sarakin san-aku). First, the Moneylenders Control Law set only vague constraints on excessive lending (and aggressive advertising). Only in 1997 did the three largest non-bank lenders agree not to loan to those who already had loans from three lenders. Secondly, the Law prohibited particularly aggressive debt collection tactics, but enforcement was weak despite even the biggest lenders reportedly abusing borrowers. Dubious practices therefore tended to become a negotiating point for lawyers seeking debt relief for borrowers, on the basis that payments of grey zone interest were not ‘voluntary’. Lawyers also focused on grey zone interest when negotiating debt relief during or before insolvency proceedings, especially when the Civil Rehabilitation Law (No 225 of 1999) was amended from 2001 to expand protections for individual debtors in possession. Background private law, namely the venerable Civil Code (No 89 of 1896) and even the Consumer Contracts Act (No 61 of 2000), proved even less useful for distressed borrowers, despite Japan’s preference for less formal legal reasoning compared especially to the Anglo-Commonwealth law regarding unfair contracts.

Another wave of litigation followed the Supreme Court’s ruling in January 2006, seeking refunds of grey zone interest paid ‘involuntarily’. By chance, the Moneylenders Control Law was to be reviewed in 2006, so a Study Group (comprising leading scholars and various stakeholder representatives) had already been set up within the FSA the year before. The Group met several times before issuing an ‘Interim Report’ on 21 April 2006. It suggested abolishing the grey zone, but did not recommend what the single interest rate should be. On 6 July, the ruling Liberal Democratic Party (LDP) and Komeito coalition recommended reducing it to the IRRL’s caps of 15–20 per cent, while leaving an exception for

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small loans. The proposed exception attracted particularly strong political criticism, so it was not included in a legislative package enacted on 20 December 2006 (Law No 115). The Moneylenders Control Law was renamed the Moneylenders Law, and the following changes were phased in:\textsuperscript{14}

- from 20 January 2007: stricter criminal penalties for unregistered lenders;
- from 19 December 2007: stricter requirements for registration, information-handling, and disclosure; a ‘suitability rule’ requiring lenders to avoid ‘unsuitable solicitation’ given the borrower’s knowledge, experience, finances and purposes; clearer rights for borrowers to examine their transaction records; restrictions on life insurance contracts over the borrower and certain debt collection practices; and tougher administrative oversight, including establishment of a new industry association;
- by June 2009: expanded minimum capital base for lenders; examinations for compliance officers within them; licensed credit reporting agencies, with new regulations regarding information-sharing among them; and
- by June 2010: further expanded capital base and mandatory qualified compliance officers; mandatory checks on borrowers’ ability to repay, a credit bureau’s report for individuals, and proof of annual income for loans more than 0.5 million yen (or loans resulting in debts of more than 1 million yen); further suitability rules prohibiting loans exceeding the borrower’s ability to repay, or one-third of annual income (absent certain liquid assets, still to be defined by regulations); and abolition of ‘voluntary’ grey-zone interest, along with amendments to the IRRL regarding certain contract terms.

Although the legislative cap of 20 per cent therefore only comes into effect from 2010, lenders are already constrained by the Supreme Court rulings on interest rates.

The sector has contracted sharply, with large ripple-on effects on the (increasingly intertwined) mainstream banking system and Japan’s macro-economy. The Moneylenders Law reforms also prompted extensive amendments to the Instalment Sales Law in 2008. For example, suppliers of one-off sales credit must be registered (like credit card companies) and must check that the retailer has not engaged in unfair sales techniques. Such suppliers as well as credit card companies must not advance credit that will make the consumer excessively indebted, and they must use a credit bureau.

\textbf{II. THREE EXPLANATORY PARADIGMS}

The rise and partial fall of unsecured consumer lending in Japan seem to challenge two still widely held views about the Japanese, and especially Japanese

consumers: they do not like debt, and they do not like law. In fact, such views—especially about the alleged Japanese aversion to law—are only some among a set of influential and quite distinctive schools of thought that have come to dominate the English language world of Japanese law studies.15

Generally, a focal point in that literature has been Japan’s comparatively low civil litigation rate. One explanation for that phenomenon, common amongst commentators during the 1960s and 1970s but still found especially in the popular press, is admittedly culturalist. Due to Confucian norms of harmony and the like, the Japanese just don’t like law. However, a second explanation propelled from the late 1970s, and underpinning Japan’s wave of civil justice reforms since 2001, is institutional barriers to litigation. Those mean that the Japanese instead can’t like law. A third explanation, influential from the 1980s as US ‘revisionist’ commentators began to emphasise that a distinctive form of capitalism in Japan required novel responses to lessen trade friction, is elite management. Bureaucrats, in particular, manage social problems so the Japanese are made not to like law.

By contrast, as the US economy regained ground over the 1990s, neoclassical economics provided a fourth explanation: the Japanese do like law, settling cases out of court in its relatively predictable shadow. As well as emphasising that legal rules often do matter in Japan, and indeed are often efficient, this ‘Chicago School’ approach argues increasingly stridently that all we need to understand Japanese socio-legal behaviour is straightforward market forces and narrowly self-interested rational behaviour.16

However, a ‘new generation’17 of ‘hybrid theorists’ remains prepared to acknowledge the impact of socio-economic and cultural institutions (such as ‘main banks’, keiretsu corporate groups, and relational contracting) that are distinctive to Japan, at least compared to conventional neoclassical perceptions of how free markets operate. These theorists are also more eclectic in their methodology, balancing the quantitative analysis favoured by neoclassical economists as the only way to true enlightenment with a renewed respect for qualitative analyses. Such approaches argue that the Japanese sometimes like law, but sometimes don’t. They also conclude that socio-legal behaviour and governance structures are undergoing gradual but significant transformations. By contrast, minimal change is perceived both by traditional culturalist theorists—communitarianism remains strong; and ironically by Chicago School economists—straightforward market forces and efficient legal rules have always characterised modern Japan.

Such views, particularly hybrid theories of Japan’s ‘gradual transformation’, are helpful starting points for fruitful analysis and debate especially about how law and socio-economic context impacts on behaviour, such as the role of various potential stakeholders in corporate governance. Commentators leading these schools of thought have offered less convincing explanations of the necessarily messier processes by which key actors in turn shape both legal and social norms. Both aspects are important, especially for those who favour more social constructionist approaches to socio-legal studies, but also for other social scientists interested in feedback loops.

The rest of Part II therefore conducts a thought experiment of how some of these diverse schools of thought might explain not only the growth of consumer credit markets in Japan, in the light of legal and socio-economic institutions, but also the recent re-regulation. Specifically, Part II.A develops caricatures of two culturalist accounts (communitarianism and liberalism); Part II.B, three economic theories (Chicago School, information economics, and behavioural economics); and Part II.C, two more political explanations. The aim is to better understand this important field by highlighting further contextual elements, embedding them in interpretive frameworks for further research and dialogue across often tense disciplinary boundaries.

A. Culture

i. Communitarianism Revisited

Communitarian accounts of Japanese law and society might explain the growth of consumer overindebtedness by highlighting the following sorts of factors. First, a strong sensitivity to status that still imbues Japanese society might lie behind the urge to keep up with colleagues at expensive nomikai (after-work drinks) and other work-related events, and indeed pay disproportionately for junior colleagues, even if struggling to cover mid-life expenses. A related pressure may be to keep up with the neighbours, despite Japan’s economic slowdown. Ostentatious spending grew during Japan’s economic boom in the 1980s,
funded by generous annual salary ‘bonuses’. It has persisted despite bonuses increasingly drying up since the 1990s.\(^{23}\)

This pressure could be exacerbated by a strong sense of shame on the part of husbands (still the predominant bread-winners) in not being able to provide adequately for the family, even without losing one’s job or position—although Japan has also experienced record unemployment levels over the last decade. Wives, traditionally responsible for household finances, may also be turning to unsecured consumer loans in their own name out of the shame of ‘not being able to make ends meet’, vis-a-vis their husbands, relatives or contemporaries.

Both, but especially husbands, may also be ashamed to admit that they had been duped by expensive scams, such as those involving dating or other service contracts. Consumers have endured such sharp practices for decades, and culturalists could point to the comparatively belated attempts at stronger legal protections as further evidence that still ‘the Japanese don’t like law’.\(^{24}\) Gambling, including the uniquely ubiquitous *pachinko* (slot machine) parlours, seems to be a similar determinant of burgeoning overcommitment.\(^{25}\)

Such theorists could also point to another strong cultural norm. An earlier quite ‘orientalist’ view was that the Japanese—and ‘Asians’ generally, for that matter—do not feel compelled to keep their promises, thus readily proposing and acquiescing to contract renegotiations despite strict legal rights. More recent comparative empirical research suggests few statistically significant differences with those from countries like New Zealand, when asked about attitudes and practices in such contexts.\(^{26}\) Even in the late 1970s, there was actually more civil litigation in ‘traditional’ rural areas, mostly comprising debt collection cases. One interpretation therefore might be that Japanese consumers have put up with extortionate loans for so long because of a cultural norm instead to perform obligations.\(^{27}\) It is also hard to imagine citizens from many other countries enduring such sharp practices for so long.

Culturalists would also point to the preference for cash transactions and loans, as opposed to credit card lending, as at least partly determined by traditional norms. More importantly, they would highlight consumer lenders’ effective targeting of middle-aged men, and then enforcement by applying pressure to dense family and social networks. The paucity of *bengoshi* lawyers, itself a

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\(^{25}\) Indeed borrowing to pay for the ¥30 trillion annually spent on *pachinko* is estimated to make up nearly half of consumer debt: ‘Rules of the Game’, *The Economist*, 29 July 2006.


revealed preference for social rather than legal ordering, parallels the instinct of most borrowers not to turn to the law for help. Likewise, even though consumer bankruptcy filings peaked at 262,000 in 2003, a similar per capita rate to many other industrialised countries (other than the US—always the exception), this represents only a small proportion of Japan’s 3 million distressed consumer borrowers. Instead, suicides continue at high rates, despite a Basic Law for the Prevention of Suicides (No 85 of 2006). As one hybrid analysis concludes, cultural factors behind the many debt-related suicides cannot be denied.

As for the recent re-regulation, culturalists might welcome the measures because lenders had not shown enough ‘benevolence’ towards borrowers—strictly enforcing their legal rights to generate massive profits since the 1990s, a period when almost everyone else was feeling the pinch in Japan. After all, egalitarianism has remained a powerful undercurrent in Japanese socio-economic ordering, although the notion that almost all citizens are middle-class has long been a myth and inequalities have worsened over the last decade.

The re-regulatory response could also be understood as a reaction against profligate spending encouraged by borrowing ever more consumer loans—symptomatic of Western, especially American, ‘moral decay’. Former Prime Minister Shinzo Abe took over in 2006 having built up considerable popular appeal over recent years by appealing to a new vision of Japan as a ‘beautiful country’—‘filled with vitality, opportunity, and compassion, which cherishes a spirit of self-discipline’.

Culturalists would also downplay the role of the courts in generating the recent law changes. Instead, the Supreme Court waited for many years for a body of case law to build up through various local courts, generating academic and some media commentary. Such ‘bottom-up’ decision-making again accords with cultural expectations in other organisational settings in Japan, epitomised by the ringisho process whereby decisions are signed off by all potentially affected employees in large companies. This approach remains in sharp contrast with the ‘top-down’ approach of the highest courts in the Anglo-Commonwealth world, which generally prefer to intervene as soon as possible in order to bind and guide lower courts and hence socio-economic behaviour. That is true to a lesser extent even for the US Supreme Court, despite more

29 MD West, Law in Everyday Japan: Sex, Sumo, Suicide, and Statutes (Chicago, University of Chicago Press, 2005).
limited jurisdiction and a more flexible approach to *stare decisis* associated with a general tendency (as in Japan) towards more ‘substantive reasoning’, because policy initiatives can be more easily blocked by legislative and presidential vetos.35

Instead, bureaucrats continued to exercise administrative guidance in restricting not only credit card liberalisation,36 but also some excesses in unsecured consumer loan business. In 1996, the head of the Banking Bureau of the then MoF strongly urged the major lenders to investigate means to limit loans. They got the message, and in February 1997 introduced self-regulation whereby loans were only supposed to be given if a borrower had no more than three major lenders.37 Meanwhile, the government’s Consumer Lifestyle Centres (CLCs) provided free advice and sometimes de facto mediation to assist the most distressed borrowers in settling disputes with their lenders.

The continuing discretionary power of Japan’s financial mandarins, which culturalists would trace back at least to pre-modern Tokugawa days,38 might also underlie the latest reforms. On 5 November 2004, soon after a Tokyo District Court ruled that the founder and president of Takefuji was guilty of Telecommunications Business Law violations by ordering employees to wiretap and follow two investigative journalists, the company called a press conference with other large lenders to report on their recent half-yearly profits. Everyone was shocked when the President suddenly announced that they wanted to buy a bank—an abrupt challenge to the much higher-status banking sector and its regulators.

The FSA (which took over from MoF in partially regulating the field) was also indignant about reports emerging over 2005 that the large lenders were violating licensing rules, despite amendments to the Moneylenders Control Law and Shusshiho (known as the ‘Loan Shark Control Law’ [yamikin kiseiho]) designed to clamp down on the most disreputable lenders. The final straw was a press conference held by the five largest lenders on the steps outside Japan’s Central Bank on 28 March 2006. Although called primarily to announce their US$50 million commitment to relief for the most severely overindebted consumers, and some scaling back of advertising, senior executives implicitly criticised talk of lowering interest rates to get rid of the ‘grey zone’. Making such public statements without prior *nemawashi* (informally sounding them out with interested parties), knowing full well that the FSA and other parts of the government were favouring such measures particularly in the wake of the Supreme Court’s judgment in January, could be seen as yet another culturally inappropriate challenge to social superiors. Just a fortnight later, on 14 April, the FSA punished Aiful by

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37 Suda (2006), above n 5, at 60.

ordering temporary closure of its 1,900 outlets. It spotlighted debt collections in breach of the Moneylenders Control Law following an (unusual) spot inspection conducted in September 2005.39

In addition, incremental legal intervention, primarily through the legislature rather than the courts and in the shadow of the bureaucracy, characterises the entire field of consumer credit since the early 1980s. Gradualist approaches also distinguish many other areas of Japanese policy-making, ranging from gender equality40 through to law school reform.41 Culturalists have associated such tendencies to norms of consensus in Japan. Gradualism can also be linked to a recent explanation for the slow development of regulatory responses to smoking in Japan, namely a social preference for emulating others.42 In that case, it required a now much clearer consensus among nations and international organisations about the need to robustly restrict such addictive products and their advertising.43 This theory also has some explanatory value in the present case. However, tougher usury laws—and certainly stricter ‘suitability rules’—are much less widely accepted around the world.44 In particular, following a controversial consultancy report in 2004, the UK government decided not to reinstate interest rate caps. Rather, ex post relief has been expanded for ‘unfair’ consumer loans.45

Culturalists can also assert that Japan’s more direct ex ante controls and other legal reforms are only being phased in over 2007–2010. That not only gives firms more time to get used to the ideas. It may also improve potential for the law to have more of a symbolic or psychological impact on all concerned. Again, they can point to commentaries favouring similar developments in areas such as gender equality and insolvency law.46

In addition, there is arguably little risk of the consumer credit reforms undermining the ingrained Japanese propensities to be punctual and—according to more recent empirical studies—to keep their promises. Indeed, it is hoped that stricter interest rate restrictions will lead to fewer loans but on better terms, more easily repaid, which should even reinforce such social norms. Even a

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44 N Howell and J Hughes, ‘Consumer Credit Regulation: An International Overview’ (April 2005), Centre for Credit and Consumer Law (Griffith University) Background Paper.
suitability rule, requiring lenders to assess borrowers’ ability to repay and restraining loans accordingly, can be seen as compatible with the communitarian ‘spirit’ of Japanese law and society. It may bring both sides into a closer and hopefully more sustainable long-term relationship.47

Both aspects can also be justified by a tradition of paternalistic protection of the weaker party, extending now beyond small businesses, tenants and employees48 to encompass a large pool of consumers. Further, the law relies on public law and enforcement, without expressly creating new private law rights (such as damages claims). Indeed, the new ‘suitability rule’ phased in from December 2007 does not provide even for direct public law sanctions for violations, although teeth are added from 2010 when lenders must check borrowers’ annual income to ensure loans generally do not exceed one-third. On the other hand, consumer lending has long been a field underpinned by few genuine social relationships, and the new legislation does retain some scope for private initiative.49

Overall, despite culturalist explanations seeming plausible in explaining the growth and characteristics of Japan’s consumer credit market, some of them also help understand aspects of the incremental re-regulation culminating in the quite far-reaching 2006 reforms. Indeed, if we accept that some—not all—of those engaged in contemporary policy-making processes are primarily influenced by traditional culturalist concerns, we can see why this group would almost certainly not oppose the recent reforms. Rather, they would probably support them.

ii. Liberalism at Last?

Those taking the view that traditional culture underpins the relative lack of ‘law in action’ in Japan did not necessarily assume that this culture would never evolve, or that the current situation was desirable. Indeed, the renowned legal sociologist Takeyoshi Kawashima suggested that modern capitalism and rights consciousness would gradually displace traditional norms,50 although in the 1980s he became less convinced that this was occurring or that it was normatively appealing.51 However, since the tumultuous 1990s a growing body of commentators acclaims the belated emergence of rights-based democracy in Japan, although sometimes expressing frustration at the messy realities and reactionary elements involved in this transition.52

49 Cf Fardieck (2008), above n 14.
Such advocates of an emergent liberal rights-based culture in Japan might tie the growth of consumer credit to ostentatious spending becoming more acceptable. They might also point to more use of formal debt collection methods, either through court filings or under the Servicer Law (No 126 of 1998), allowing companies with bengoshi lawyers as directors to expand debt collection services. Overindebted borrowers also increasingly filed for bankruptcy, although suicides remained common. Finally, the Supreme Court’s willingness to intervene from the late 1990s could be connected to growing constraints on Japan’s bureaucracy, and broader judicial reform aimed at securing a stricter rule of law.\textsuperscript{53}

Nonetheless, this account really only explains the timing and nature of the recent re-regulation. Thus, liberals may hope that tougher interest rate caps, in particular, will crowd out thousands of smaller, lower-tier lenders. Many are probably only nominally legal. Often they are already engaged in illegal practices—even the bigger, publicly listed lenders (such as Aiful) have been increasingly exposed.

Secondly, a liberal vision for Japan is arguably promoted by ensuring, through caps but also the suitability rule, that smaller volumes of loans extended by more reputable companies will be based on more genuine consent. This should add legitimacy to liberalism’s core ideology of free choice and self-responsibility, and thus further improve ‘contracts consciousness’ in neighbouring fields.

Thirdly, enforcement against defaulters becomes more likely to occur through lawyers or servicer companies. On the other hand, the suitability rule scheduled for 2007 lacks direct public law sanctions for violations. It is also necessarily vague. There may also still be uncertainties regarding the rules to be implemented by 2010 prohibiting lending when loans add up to more than one third of the borrower’s income. All this means more scope for lawyers to be involved in advising consumers and even perhaps regulators. With small waves of graduates beginning to pour out of the law schools, there is a need for them to find gainful employment in such new fields—even though more mundane than the corporate law practice in the ever-expanding Tokyo law firms.\textsuperscript{54}

Engaging more lawyers in both enforcing and resisting enforcement of consumer debt will also squeeze Japan’s seedy world of yakuza gangsters. Already, their ability to extort money from companies by abusing shareholder meetings (as sokaiya) has been constrained by corporate law reforms. Notably, 1993 amendments drastically reduced the filing fee for filing shareholder derivative actions, generating hundreds of suits from a negligible base.\textsuperscript{55} More mainstream income sources for yakuza—prostitution, gambling and drugs—have probably

\textsuperscript{53} See Kozuka and Nottage, above n *, with further references.


\textsuperscript{55} MD West, ‘Why Shareholders Sue: The Evidence from Japan’ (2001) 30 Journal of Legal Studies 351.
also been affected by stricter laws and enforcement since 1992.\textsuperscript{56} Thus, re-regulation of the consumer credit indirectly helps tackle another ‘dark side of private ordering’ in Japan.\textsuperscript{57}

A fourth positive reform, for liberal rights theorists, is that the decision to extend a loan itself has come to be regulated by obligatory reference to a qualified credit bureau. Such bureaux must have substantial scale,\textsuperscript{58} so that the regulation effectively deters excessive lending. The newly introduced regulation echoes the FSA Study Group Report that emphasised the need to promote information sharing among lenders over concerns about borrowers’ privacy.\textsuperscript{59} Although the FSA Report noted those concerns, its balance of privacy protection versus information-sharing appears to be the converse of the Report of a Study Group co-sponsored by MOF eight years previously.\textsuperscript{60} Promotion of information-sharing may indicate that Japanese society preferred more paternalism on this issue, rather than the liberalism that would leave the matter to autonomous ordering by market players. The recent shift is also striking given broader social (and business) concerns about other privacy issues in Japan nowadays, reinforced by the Personal Information Protection Law in effect from 2005, as well as growing evidence of many failures in the supposedly leading credit-information system found in the US.\textsuperscript{61}

Overall, compared to the culturalists who assert that conventional or neo-communitarian norms and institutions help best in understanding socio-legal developments in Japan, liberal theorists struggle to explain patterns in consumer lending growth. They become more convincing when analysing recent developments although, as explained further in Part II.C below, the process as well as the outcomes are much more complex than anticipated by liberal theorists. Further, if we again assume that at least some major policy-makers were driven by such liberal concerns, it becomes apparent that they too would have largely supported the recent reforms.


\textsuperscript{58} According to the draft Ministerial Order, a bureau must have 100 or more members and assess ¥5 trillion or more of outstanding debt.


\textsuperscript{60} Outlined in Part III.A.5 of Kozuka and Nottage (2007), above n 1.

B. Economics

i. Chicago School

The Chicago School of neoclassical economics would present a straightforward account. Consumer credit growth would be seen as deriving from a deregulated market, with interest rate caps higher than market-clearing rates or weakly enforced. Rates were high because risky borrowers took out small loans, and because formal debt collection was impeded by the bengoshi cartel. The recent re-regulation would be explained by ‘public choice’ theory. The Supreme Court intervened because it divined new preferences of the LDP, seeking to corner more consumer votes and to help Japan’s banks squeeze out the growing competitive threat of non-bank lenders.62

However, there is little empirical evidence for such assertions, and laissez-faire arguments played little role in the reform debates. More remarkable is the lack of attention to more basic insights from micro-economics, such as the possible consequences of imposing price controls and hence generating excess demand, as well as to more recent and persuasive schools in economics.

ii. Information Economics

Chicago School economics assumes perfect information. But that is untrue in the market for credit: there is asymmetry of information between the creditor and the borrower. Traditional proponents of regulation tend to emphasise the borrower’s lack of information about the loan terms, but the creditor also finds it costly and difficult to distinguish riskier from less risky borrowers. Because of the latter feature, excess demand and credit rationing can occur even without an interest rate cap or any other regulation. When the lender raises the interest rate, the less risky borrower leaves the market while the riskier borrower remains. This is typical of ‘adverse selection’ in a market with imperfect information.63

So the lender may not end up with an interest rate high enough to maximise profit, allowing for the default risk. If this rate is lower than the level that clears the market, there will be an excess demand for credit.64 Thus the arguments of Chicago School economists are only half true: the problem of excess demand cannot necessarily be solved by just doing away with the interest rate cap.

Faced with this adverse selection problem, a borrower may signal to the lender that she is less risky and deserves a lower interest rate. She may, for example, accept loan terms allowing collection day or night. Or she may have her loan personally guaranteed by close relatives. However, if the legislator considers these

62 See further Kozuka and Nottage, above n .
kinds of signalling undesirable, capping the interest rate can become an attractive public policy response.\footnote{Similar ideas lie behind efficiency-based rationales for regulating private contracting: P Aghion and B Hermalin, ‘Legal Restrictions on Private Contracts Can Enhance Efficiency’ (1990) 6 Journal of Law, Economics and Organization 381.}

The ‘sweat box’ business model, developed by US credit card lenders,\footnote{Mann (2007), above n 7.} but arguably also adapted by most consumer credit companies in Japan, may be another private arrangement to solve the problem of adverse selection. If the interest rate is set high enough, only risky borrowers will remain in the market. Credit companies, recognising this problem, no longer expect the principal to be repaid but rely on interest payments for profitability. This business model also benefits the credit companies by saving costs in more fully evaluating the risks of the borrower. Again, however, a credit company employing the ‘sweat box’ model may also be more likely to resort to harsh collection methods. If the borrower, for her part, is faced with further information asymmetry and does not accurately assess in advance how harsh the collection will be, capping the interest rate can correct for such borrower behaviour.\footnote{Technically, the focus will be on the difference between demand curves assuming full or no information about collection methods: Y Tsutsui et al, ‘Jogenkinri Kisei No Zehi: Kodo Keizai-gakutei [Pros and Cons of Regulating High Interest Rates: A Behavioural Economics Approach]’ (2007) 22 Gendai Finance 25.}

These justifications of the interest rate cap from information economics may echo traditional arguments that justify usury law as a tool to fend off unscrupulous or abusive lenders.\footnote{L Drysdale and K Keest, ‘The Two-Tiered Consumer Financial Services Marketplace’ (2000) 51 South Carolina Law Review 590; Mann and Hawkins (2007) above n 8, at 906.} Their proponents will advocate the idea of maintaining the IRRL and therefore favour the re-regulation of Japan’s consumer credit. However, for the interest rate cap to be justified, empirical data on the types and practices of borrowers and creditors were required. Yet, such questions and comprehensive data were not forthcoming during the quite unsophisticated re-regulation process in Japan.

iii. Behaviouralism

Lessons from an even newer branch of economics were even less evident in the recent re-regulation, despite helping greatly in expanding the rise of consumer credit in Japan. Behavioural economics, drawing on evidence from social psychology to challenge the simplistic notions of wealth-maximising behaviour underpinning mainstream neoclassical economics, has been particularly influential over the last decade in understanding consumer behaviour, especially in credit markets.\footnote{S Block-Lieb and E Janger, ‘The Myth of the Rational Borrower: Rationality, Behaviouralism and the Misguided “Reform” Of Bankruptcy Law’ (2006) 84 Texas Law Review 1481; CR Sunstein, ‘Homo Economicus, Homo Myopicus, and Economics of Consumer Choice: Boundedly Rational Borrowing’ (2006) 73 University of Chicago Law Review 249.} A recent field experiment in unsecured consumer lending in
South Africa did find some evidence of adverse selection, but it was quite weak, but the study also found very strong effects from lenders’ marketing exploiting behavioural or psychological weaknesses. Firms therefore seemed able to raise aggregate demand without suffering too much adverse selection, hence dulling incentives for price competition. Surprisingly, however, lessons from behavioural psychology and economics have not yet been applied in any Western-language analyses of Japanese business or consumer law, even in the field of consumer credit.

After decades of studies 'the optimism bias is considered one of the most robustly confirmed biases in cognitive studies and social psychology'. Individuals significantly overestimate their chances of good things happening to themselves, while under-estimating chances of bad things. This finding has helped explain why individuals persist in addictive behaviours, such as consuming cigarettes and alcohol, despite increasingly evident health risks. Implications have extended beyond education to the design of regulation and product liability laws. Later tests confirmed the bias at work in student decisions about borrowing, and these insights have recently been extended to try to explain and address over-optimistic borrowing in the contexts of the credit card industry and bankruptcy policy. Cross-cultural experiments have also found that the Japanese are also significantly more likely to expect negative events to occur to others than to themselves. Over-optimism, especially in this sense, encourages consumers to take on loans leaving too little margin for error, finding themselves overcommitted when disaster strikes in the form of lost income or employment, family breakdowns or medical emergencies.

Another well-established bias is 'the illusion of control'. Individuals behave as if (more or less) chance events are subject to control, and do not distinguish events involving chance versus skill when undertaking activities involving some control such as choice. Hence, they pay more for lottery tickets when allowed


to choose numbers, but also believe themselves more immune from harm when drivers rather than passengers, or when cooking at home instead of consuming prepared foods. Advertising emphasising choice by borrowers—loan amounts, repayment options, different lenders—feeds into such an ‘illusion of control’.

A third common cognitive bias is ‘availability’: individuals overemphasise things that spring readily to mind. Conversely, borrowers find it harder to recall past expenditures, encouraging them to take on more debt. The publicity given to (near-)cap interest rates also may lead lenders and even borrowers to consider them ‘normal’, even if a particular customer is objectively more low-risk and therefore deserving of a lower rate.

Such borrowing behaviour may also be reinforced by ‘social norm cascades’, which social psychologists have highlighted in many other fields. ‘Herd behaviour’ emerges as consumers increasingly start spending and then borrowing at high interest rates. More recent research has further established that many individuals are ‘hyperbolic discounters’: they prefer to discount future payments based on a changing interest rate, rather than a constant one. It becomes mathematically extremely complex to build in such discounting for a myriad of events that can affect potential lenders over longer ‘lifecycle’ periods.

Computation errors might lead to under-borrowing, but are much more likely to lead to overborrowing given biases such as over-optimism and illusion of control.

Even more broadly, experiments and literature are increasingly proving aspects of ‘social influence theory’, as a complementary field of social psychology. For example, various types of influence can direct behaviour and produce insufficiently reflective compliance. One is ‘consistency’: people tend to comply when a request is combined with a reason—even a spurious one. Another type of influence is ‘reciprocation’: people tend to repay when receiving some-
thing from another, even unsolicited. A third is ‘social proof’: people view actions as appropriate if (projected as) being done by others. Advertisers often exploit such tendencies, for example by giving reasons why loans should be taken out, offering ‘discounts’ on rates, or emphasising certain services as the ‘fastest-growing’ or themselves as the ‘largest’ lenders. Particularly through wording and ‘framing’, advertisers increasingly play on such psychological weaknesses.

More broadly, suppliers can also take advantage of the fact that consumer contracts tend to be presented at the end of a course of negotiation. Thus, for example, mainly to preserve self-esteem consumers allow perceived ‘sunk costs’ to influence their decision to sign off. Too much emotional stress, or sometimes too little, can also trigger irrational responses. Very recent research even suggests that the ready availability of credit can disrupt the brain’s evolved mechanism for weighing pleasure versus pain.

Such insights from social psychology and the ‘new wave’ of behavioural law and economics, increasingly applied to explain the growth of consumer credit markets and concomitant overindebtedness, seem likely to be playing a major role in Japan as well as many other countries. However, specific lessons appear to have been overlooked in the reform process. These disciplines also offer less explanation for why and how the 2006 reforms came about.

At most, new social norm cascades may have evolved as media attention focused on a string of incidents and partial reforms over the years. In addition, bringing down the interest cap to 20 per cent might also have seemed ‘fairer’ due to an innate propensity to collaborate that has been established by experimental psychology involving the ‘Ultimatum Game’. The rules of this game involve player X proposing a division of $100 between himself and player Y, which the latter can accept or reject. If accepted, both players keep the portions proposed; if rejected, both get nothing. Conventional economic accounts of rational wealth-maximising would predict that X would propose to keep $99 and Y would accept $1. Yet in actual experiments, replicated in both developing and all around the world, X offers much more. In other words, people

82 As traditional culturalists have emphasised, perhaps in too Orientalist a manner, this sense of repaying (social) debts—giri—remains a strong norm in Japan: see, eg, S Scott, ‘The Role of Obligation in the Japanese Marketing System’ (1998) 53 Business Quarterly 92.
83 Harris and Albin (2006), above n 72, at 438–40.
just seem to have an innate sense of fairness. However, that does not explain why Japanese policy-makers and citizens decided on a new interest rate cap of 20 per cent, rather than say 15 or 25 per cent. Perhaps it was influenced by the ‘availability’ heuristic, especially in light of the judgment of 13 January 2006 and its run-up.

If behaviouralist insights had played more of a direct role, moreover, they ought to have generated more focused reforms.\textsuperscript{88} Nonetheless, even the occasional behavioural economist would have found some of the 2006 reforms to represent a positive step forward, counteracting some of the many biases and other psychological problems exacerbating consumer overindebtedness. This group would probably therefore join with the culturalists—whether (neo-) traditionalist or liberal—and possibly some ‘information economists’ in opposing Chicago School economists’ call for more deregulation, instead of the re-regulation that occurred.

C. Politics

i. Elite Management

‘Management by elites’—big business, conservative LDP politicians, and especially the bureaucracy—became a popular paradigm in the English-language literature for understanding developments in Japanese law and society from the 1980s.\textsuperscript{89} In consumer law fields such as product liability since the 1990s, however, judicial innovation not only helped prompt government intervention and industry responses, but also continued afterwards.\textsuperscript{90} And borrowers consistently turned to the legislature, lawyers and the courts, rather than relying on the bureaucracy. Those partial to the elite management model would probably join Chicago School economists, somewhat ironically, in opposing such developments—fruitlessly, as it turned out.

ii. Less ‘Patterned Pluralism’

Patterned pluralism is a different analytical framework advanced primarily to analyse Japanese politics from the 1980s.\textsuperscript{91} On the one hand, it argued against a model emphasising bureaucratic dominance, and instead emphasised pluralistic aspects or responsiveness of Japanese politics to social demands. On the other hand, pluralism in Japan was said to be ‘patterned’ in the sense that the interest

\textsuperscript{88} Kozuka and Nottage (forthcoming), above n 2.

\textsuperscript{89} F Upham, \textit{Law and Social Change in Post-War Japan} (Cambridge, Harvard University Press, 1987).

\textsuperscript{90} See Nottage (2004), above n 10; and further Kozuka and Nottage, above n 9.

groups as players in the political process were less volatile than envisaged by most political theory. After the drastic changes in the political and economic environment in the 1990s, as well as the reform of election system in 1994, this framework itself may need to be revised. Reform of regulation on consumer lending in 2006 provides a good case study testing the extent to which the political process deviated from the analytical framework.

The main players in the regulatory reform in this area are moneylenders, borrowers, lawyers and other advocates of borrowers, fragmented regulators, and neighbouring industry sectors—especially banks. In retrospect, moneylenders entirely lost out in the political process and their arguments were hardly heard. Lawyers appear to have achieved more than they wanted, since even the pro-consumer lawyers had not gone so far as to demand total abolishment of grey zone interest, at least before the Supreme Court decision of 13 January 2006 on acceleration clauses. Banks did not participate in the process actively, as is shown by the fact that no one spoke on behalf of the banking industry at the FSA Study Group (evident from minutes listing invited participants). Considering all this happened within the jurisdiction of the FSA, this reform seems to support the decline of patterned pluralism over the last decade.

A closer look, however, reveals that the issue was the one least likely to invoke patterned pluralism. First, most of the players had diverse or even conflicting interests within themselves. Moneylenders consisted of large consumer loan lenders, well-known through advertisements on TV or in subways, and smaller or even illegal ones. Ironically, it was the largest ones that became the main target of criticism at the later stage of the reform, although they offered cheaper loans than smaller or illegal lenders. As regards lawyers, not all of them were on the consumers’ side: some were said to be associated with moneylenders, typically illegal ones. The position of the banks was not straightforward, either. As competitors to the non-banks as lenders to consumers, the more stringent regulation over non-banks was preferable. However, the banks were also major suppliers of the funds to large consumer finance companies, and sometimes shareholders of them (for example, Promise and Aiful). The conflicting interests they held made it difficult for them to exert any significant influence over the reform process. Secondly, even the larger lenders within the...
non-bank industry did not have close communication channels with the supervising FSA, unlike the banks. Further, ‘borrowers’ as such could not readily form an interest group, since borrowers do not deliberately become overindebted. Once they become overcommitted, their concern is how to cut down their own debts, not what regulatory institution the society needs. In sum, it is not surprising that the process was not as patterned as even Muramatsu’s theory typically predicts.

Still, the process of the reform was pluralistic in the sense of being responsive to social needs. The series of decisions by the Supreme Court was the product of campaign-like litigation led by pro-consumer lawyers, in Japan’s post-War tradition of ‘policy-making litigation’. Even a major NGO representing borrowers was invited to the FSA Study Group and given an opportunity to make a presentation. Particularly after the FSA ordered the suspension of business against Aiful in early 2006, the mass media also reported the tragic circumstances afflicting many overcommitted borrowers. Hitherto, the media instead had been reluctant to take up this issue due to the contribution of consumer loan companies to TV advertisements at midnight hours. The expansion in media coverage in turn affected the reform process. Finally, the exception for small loans indicated in the Basic Policy and included in the first draft of the amendment was criticised by a young parliamentarian who by chance was serving as the parliamentary secretary for the FSA (seimukan). Exceptionally in Japanese politics, he even resigned from his position. As this triggered the withdrawal of the exception, even the LDP’s capability for coordination through a system still emphasising seniority among its politicians turned out to have declined in favour of general public opinion.

Partly due to this unique constellation of interests and powers of relevant parties, the business of moneylenders—consumer loans in particular—was re-regulated through the process of a much less patterned pluralism. Such responsiveness is important, of course, in a democratic state. However, too much can lead to populism and pose a threat to responsible governance. As this re-regulation was triggered by court decisions culminating case-by-case efforts of lawyers dealing with cases involving overindebted borrowers, there was a real danger of falling in the pitfall of populism and losing a holistic view of the issues.

97 S Ide, Sarakin Hokai [The Collapse of Loansharking] (Tokyo, Nakagawa Shobo, 2007) 68.
98 Kozuka and Nottage (2007), above n 1.
100 Suda (2006), above n 5, at 203 et seq.
101 Ide (2007) above n 97, at 70.
102 The third position in the FSA to be appointed from among MPs, after the Minister (a senior politician) and the Vice-Minister (fukudaijin). The seimukan position is occupied by an earlier-career politician, and was introduced along with centralisation of ministries from 2001. However, it remains a more formal position rather than one involving substantial power in decision-making.
Thus, during the course of the reform debates, lenders often justified their opposition towards abolishing the grey zone by alleging that lowering the effective caps on interest rates would drive borrowers who are high credit risks out of the lending market into the clutches of illegal lenders. This issue of possible excess demand created by price (interest-rate) regulation has not been taken up seriously, notwithstanding the fact that Professor Naoyuki Yoshino, the economist chairing the Study Group, mentioned it in the Interim Report in mid-2006. Apparently no one tried to work out the anticipated extent of such excess demand, still less propose a realistic solution to it. Instead, arguments were dominated by anecdotes about borrowers taking out too many loans and suffering from harsh collection techniques.

Excess demand is a serious problem because it represents borrowers who are poor credit risks under the interest rate cap and unable to obtain credit in the legal market. The issue may need to be examined in a broader perspective extending to the overall design of the financial sector. Alternatively, it could be argued that such borrowers should be cared for by social welfare policy. Economic growth through further progress in structural reform of the national economy as a whole might also be worth considering. Such forward-looking arguments, however, were hardly heard during the course of reform in 2006. Without them, responsiveness resulting in re-regulation could easily be transformed into populism and pure sympathy with ‘poor’ borrowers.

On the other hand, despite subsequent political compromises, the main discussion and outline regarding many narrower issues did emerge from the quite structured process of Study Group deliberations. This reveals a still strong tradition of policy-making by shingikai (deliberative council), even though that is also generally being reinvented through greater transparency (for example, disclosure of minutes online) and broader participation (for example, NGOs and media representatives). As suggested by some, even in the process of deliberations by the powerful Judicial Reform Council in the late 1990s, shingikai deliberations offer the potential for bureaucrats to maintain some control over the agenda, at least compared to policy-making centred on Parliamentary committees. Compared to other areas of consumer law reform, such as product liability in the early 1990s, consumer credit re-regulation debates primarily revolved around the FSA Study Group, constraining raw populism and restoring some patterning to contemporary lawmaking in Japan.

107 Miyazawa (2007), above n 52.
III. CONCLUSION

Although each theory proves especially difficult to test comprehensively in this field, some of the theories commonly advanced to explain Japanese law and behaviour in socio-economic context seem less plausible than others. The most convincing explanations for the rise of unsecured consumer lending derived from revamped (not particularly ‘Confucian’) culturalist theory and newer (especially behavioural) economics. But the partial fall illustrates the increasingly less patterned pluralism—perhaps even populism—of Japanese politics. Compared to insolvency reform in Japan over the last decade, the process also had little visible input from institutional lenders, but more from consumer groups or well-disposed politicians. Consumer credit re-regulation seems quicker and more comprehensive, albeit maintaining a strong focus on interest rates—perhaps partly for symbolic effect.

This perspective therefore emphasises complex interactions among specific interest groups, rather than generalisations about culture or evolution to meet functional needs of society, in explaining both the process and some substance of the reforms. A similar approach has been taken to reforms in Canada, albeit identifying stronger interests on the part of regulators and lawyers. However, economic realities as well as some specific cultural traits may help to explain how problems emerged in the first place, in Canada but also other industrialised countries. Lessons from the rise and partial fall of consumer credit in Japan therefore provide another useful reference point for accurately comparing other parts of the world.

In particular, the growth appears to have involved much more than the competitive, fully informed and rational markets emphasised by Chicago School economics (Part II.C(1)). Likely distortions included information asymmetries (Part II.C(2)), but also difficulties in processing even shared information, as well as other problems highlighted by behavioural economics (Part II.C(3)). In addition, some—not all—insights from revitalised culturalist theory (Part II.A(1)) seem plausible in the Japanese context: shame, gender and family roles, attitudes towards keeping promises and suicide, and the willingness to countenance extra-legal enforcement (through *yakuza*) over legal norms and institutions.

On the other hand, conventional culturalist theory becomes much less compelling when trying to explain the recent changes. Although the Supreme Court took seven years to build up to its January 2006 judgment, that progression does suggest a transformation in the judiciary’s self-awareness: becoming the ‘people’s champion’. This offsets some more traditional traits, namely the

111 Cf, eg, Mann (2006), above n 3.
112 T Hotta, ‘The Courts as the People’s Champion’ (2007) 34 Japan Echo 44.
focus on public rather than private law in such cases, and the emphasis on compensating individual plaintiffs rather than overall effects of such rulings on society or the policy-making process. On the other hand, those very traits plus various limits to the recent reform package suggest that Japan has not yet achieved ‘liberalism at last’ (Part II.A(2)). That theory is more persuasive in explaining the current re-regulation, however, compared to explaining the growth of consumer credit due to allegedly new ‘liberal’ social norms of ostentatious spending.

Nonetheless, both advocates of conventional culture and of liberal culture would probably join with behavioural economists and political pluralists in supporting the recent package of reforms, albeit to differing degrees and for somewhat different reasons. Precisely because Japan’s law reform processes do indeed seem to be becoming more pluralist, such a coalition can more readily emerge to overcome the only groups who would predictably oppose the package: those operating under the elite management model or, especially, the Chicago School (including consumer credit industry interests). Since those groups turned out to be fewer or less powerful, they largely lost out in the reform process.

These conclusions may also resonate with developments in this field in other countries. They also point to a further set of implications for studies of comparative consumer credit and consumer law in general. For example, Japan’s recent experience confirms that overall economic deregulation does not exclude the possibility of more focused re-regulation when the socio-economic costs become visible. This tendency is generally apparent in post-industrial societies world-wide, yet consumer protection has come under increasing threat in some countries such as Australia. Australia’s refusal to move towards the strengthened European regime for consumer product safety thus contrasts with Japan’s partial re-regulation, also achieved in late 2006. As such countries become increasingly closely linked, including recently via Free Trade Agreements, more pressure may be brought—somewhat ironically—to level the playing field and address specific socio-economic problems through focused re-regulation. Nonetheless, to maximise economic benefits and broader social legitimacy, the approach to such consumer law reform should also be harmonised. Harmonisation should address the features of good law reform processes, as well as basic substantive issues about the rationales for intervention in consumer credit markets and therefore the best mix of regulatory instruments.

Those more normative issues are explored further elsewhere. In brief, at a macro level, re-regulation may be justified because of Japan’s growing commitment to both markets and social welfare, creating incentives to take excessive

114 Kozuka and Nottage (forthcoming), above n 2.
credit risks, as well as increasingly evident negative externalities. At a micro-level, behavioural economics spotlights pervasive biases that tend to be exploited by consumer credit suppliers. But the regulatory response therefore probably demands more focused disclosure requirements, suitability rules, measures to simplify and standardise a variety of terms used in consumer loans, and opportunities to invoke ex post private law remedies. Capping interest rates at 20 per cent appears a rather crude second-best solution, albeit born of growing frustration with failure of other instruments to constrain an increasingly problematic industry. Neoclassical economists’ longstanding objections to interest rate controls were largely ignored. But so were more normative arguments about whether the concomitant denial of credit to the highest risk borrowers can be justified by broader interpretations of autonomy maximisation, or indeed other socio-political values.

Such issues raise empirical questions, but they also must be considered in the light of other theoretical debates about contemporary inter-relationships between law and socio-economic context, illustrated here for Japan. This chapter already shows the usefulness of a more eclectic and interdisciplinary methodological toolkit, open to arguments and evidence from cultural studies and diverse schools within economics and political science, especially when examining both the growth of consumer credit and possible legal responses.

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Making Sense of Nation-Level Bankruptcy Filing Rates

RONALD J MANN

I. INTRODUCTION

Much of the developed world has experienced a similar pattern of spending, debt, and insolvency over the last 20 years. First, as national income and consumer spending rise, the level of consumer debt inevitably increases. When consumer debt becomes commonplace, the incidence of household financial distress rises, with burgeoning rates of insolvency not far behind. What once was a problem only for merchants and businesses quickly becomes a risk that confronts all classes of the populace, rich or poor. As this pattern has played out, financial distress and insolvency have become front-page news around the globe. European countries that did not even have bankruptcy systems 20 years ago now confront a rising tide of distress that overwhelms judicial and administrative processes as quickly as legislatures can create them.

1 See A Bennett, ‘Bankruptcies on the Rise, Figures Show’, <www.news.com.au>, 10 July 2007 (Australian story noting that “[t]he high cost of living and easy access to credit have led to the highest number of bankruptcies in [New South Wales] for more than 20 years’); ‘Sounding the Retreat’ (13 July 2006) The Economist (discussing rampant ‘overindebtedness’ associated with willingness of British to ‘borro[w] with abandon’); ‘The FSA Flinches’ (7 September 2006) The Economist (‘Reformers worry that too many Japanese are borrowing more than they can hope to repay’). Although the topic is newsworthy in Canada, Canadians find themselves in the unusual situation of congratulating themselves on a recent decline in filing rates. Fewer Canadians Going Bankrupt Despite Rising Debt Levels, 5 February 2007 (government press release suggesting that ‘low unemployment allowed consumers to cope with higher debt levels’).

Yet despite a general upward trend in filing rates, stark differences in nation-level filing rates persist. For the most telling example, consider the United States and the United Kingdom, the two largest English-speaking economies. In 2004, 930 out of every million UK residents sought formal insolvency relief, but US residents sought such relief at a rate more than five times as high (5,500 out of every million).3 Consider Canada and Australia, the two largest Commonwealth economies. Commentators note the similarity of their systems for providing bankruptcy relief,4 but the rate at which Australians and Canadians seek insolvency relief differs sharply. As of 2004, there were 1,300 filings per million in Australia, but more than twice as many (3,100) filings per million in Canada.

Governments concerned about rising rates of financial distress can respond in various ways. They might try to alter individual behaviour, hoping to limit financial distress by discouraging spending.5 Alternatively, they might intervene in credit markets, hoping to limit overindebtedness at the source.6 Countries that ignore the problem face the possibility of ending up like South Korea, which recently spent billions of dollars to bail out leading financial institutions that faced crippling levels of default and insolvency,7 or the United States, which faces a growing crisis centred on rapid increases in foreclosure rates.8

3 I note Iain Ramsay’s point that comparisons of filing rates across national boundaries are complicated not only by differences in the formal liquidation systems, but also by differences in the possibilities for seeking relief through the multifarious rehabilitation systems, which may be more or less formal or voluntary. I Ramsay, ‘Comparative Consumer Bankruptcy’ (2007) Illinois Law Review 241, 260–2. In this Chapter, however, I cannot undertake to examine all such systems. Instead, I focus on the major formal national-level systems. Thus, for example, I do not include county court administration orders in the statistics for the UK. A complete understanding of the UK pattern would require assessment of the interaction of those orders with the bankruptcy and IVA systems that I do consider. It is enough for this Chapter to suggest (based on the apparent magnitude of county court administration orders) that the UK filing rate would remain relatively low even if I included those filings in calculating the UK filing rate.


5 That approach would not be congenial in many countries. The US, for example, has depended for decades on consumer spending to drive economic growth. L Cohen, A Consumers’ Republic: The Politics of Mass Consumption in Postwar America (New York, Knopf, 2003). Similarly, Japanese reformers focused on consumer behaviour have worried that consumer spending has been too low, not that it has been too high. S Kozuka and L Nottage, ‘Re-regulating Consumer Credit in Japan: Culture, Economics and Politics in Contemporary Law Reform’ in J Niemi et al (eds), Consumer Credit, Over-Indebtedness and Bankruptcy: National and International Dimensions (Oxford, Hart Publishing, 2009).

6 For example, the UK’s Office of Fair Trading and Department of Trade and Industry (recently superseded by the Department for Business, Enterprise and Regulatory Reform) have both been aggressive in this way in responding to the perceived problem of overindebtedness in the UK. See, eg, OFT, Consumer Credit (Advertisements) Regulations 2007 (SI 2007/827); DTI, Fair Clear and Competitive—The Consumer Credit Market in the 21st Century (White Paper) (Cm 6040, 8 December 2003).


Perhaps the most common response has been to amend the legal system for dealing with financial distress. Even if financial distress is an inevitable by-product of a modern capitalist economy, differences in the formal legal system affect individual responses to financial problems. Most obviously, the rise of consumer debt in recent decades has led to the creation of new bankruptcy systems in several continental European jurisdictions.

Even in countries that have had bankruptcy systems for many years, the rising levels of insolvency in recent decades have driven major reforms. Policymakers have struggled with whether—and how—to alter their systems. Hence, the US has adopted reforms designed to limit access at the same time as the UK and Japan have implemented reforms to encourage more filings. Which approach is correct? Should legislators permit access by a greater number of debtors, to encourage entrepreneurial risk-taking? Or, should they limit access to a smaller number of debtors to lower the moral hazard of an easy release from obligations? What is the best way to filter out the abusive filings from the ‘honest but unfortunate’ debtors for whom policymakers design the systems?

The disparate responses reflect the likelihood that variations in filing rates rest on different factors in different countries. Some of the variation is attributable to different levels of indebtedness. Some of the variation is attributable to different cultural attitudes about financial failure. Some of the variation is attributable to the accessibility of the legal system as a remedy for irremediable financial distress. Some of the variation is attributable to the availability of informal systems of relief. Yet it is not easy to disentangle how those different attributes affect the aggregate nation-level filing rates. This Chapter explores the possibility that aggregate empirical data can shed light on that question, and analyses the policy implications of the differences in nation-level filing rates.

First, Part II explains why it is important as a matter of policy to understand whether high or low filing rates stem from economic, cultural, or legal causes. Without understanding why rates are high or low, it is impossible either to assess whether the rate of filing is too high or too low, or to design policies likely to move rates in the appropriate direction.

Drawing on prior work about credit card markets, Part III uses aggregate data to distinguish between the economic explanations for filing rates and the cultural and legal explanations. Two findings are salient. First, the bulk of the uniquely high filing rate in the United States appears to be attributable to

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10 See sources cited above n 2.

11 For a collection of papers on that subject, see Part IV of *Consumer Bankruptcy in Global Perspectives*, above n 2.


13 The phrase is from *Local Loan Co v Hunt*, 292 US 234, 244 (1934).

14 Mann, above n 7.
economic conditions, not cultural attitudes or the legal system. Second, after controlling for economic conditions, Canada’s filing rate is by far the highest of any of the countries for which adequate data is available, the other countries being the United States, United Kingdom, Japan, and Australia.15

Part IV offers tentative hypotheses to explain the more robust findings in Part III. Thus, it considers both why Canada’s propensity to file is so much higher than that of the US, and why Australia’s is so much lower. The discussion of Japan and the United Kingdom is more tentative, primarily because of limitations in the data16 that make the statistical findings considerably more ambiguous than they are for Canada, the US, and Australia. Generally, I hypothesise that ‘back-end’ issues related to the timing of a discharge and the payments required to obtain it are relatively unimportant. ‘Back-end’ issues matter primarily to the relatively small sector of bankruptcy filers with significant income or assets. For the great mass of potential filers who have little or no income or assets, the most important issues are ‘front-end’ barriers to filing, whether they come from procedural obstacles or from cultural attitudes about financial distress.

Part V concludes with a normative assessment of those ‘front-end’ barriers. Because those barriers tend to bar filings by the desperately insolvent (the ‘low-income, low-asset’ or LILA debtors), they reflect poor policy choices. The net social benefits of returning the LILA debtors promptly to productivity support a simple and effective system of relief for those debtors.

II. WHY THE REASONS MATTER

The first step in analysing nation-level filing rates is to confront the matrix of factors that affect those rates. Although a rigid categorisation is arbitrary, it is useful to distinguish among three different types of factors, each of which relates to financial distress and bankruptcy in a different way and each of which has different policy implications.

A. Legal Explanations

Although I am predisposed to doubt the importance of purely legal explanations,17 I start there, primarily because of the conventional wisdom that legal

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15 I study these countries because they are the only ones for which I have been able to obtain a sufficiently long time series of data to permit meaningful quantitative analysis.

16 In the case of the UK, the apparent problem is that England and Wales have one bankruptcy system, Scotland another, and Northern Ireland no system at all. The data for my control variables extends to the entire UK and I have been unable to locate a time series of data for my control variables that is limited to England and Wales. In the case of Japan, the apparent problem is an unusually long recession that has lasted throughout the study period, so that the data does not include filings from the same mix of economic good and bad periods as the other countries.

17 See Mann, above n 7, at 96–8 (explaining that differences in legal protections have little relation to the pattern of debit and credit card use).
explanations are central to the problem. The intuition relies on a rational actor conception of the debtor: fewer debtors file for bankruptcy in countries with bankruptcy systems that offer relief that is less generous, and more debtors file for bankruptcy in countries that offer relief that is more generous. The analytical premise is that the bankruptcy discharge provides an economic benefit to those that file, and systems in which the benefit is greater should produce more filings. The literature written from this perspective suggests that the key variables in explaining filing rates are the ready availability of a discharge, the types of debts excepted from the discharge, and the scope of required post-bankruptcy payments.\(^{18}\)

That explanation is consistent with the US filing rate. The world’s highest filing rate is associated with a system in which a discharge is almost automatically and immediately available and with no general requirement of post-bankruptcy payments to creditors. Similarly, Michelle White’s work shows that the propensity to file is higher in US jurisdictions with higher exemption levels and thus more generous bankruptcy relief.\(^{19}\)

The conclusion that the level of filing rates depends for the most part on the legal system makes it easy to adopt responsive policies. For example, countries like the UK and Japan seek higher rates of bankruptcy filings to speed the resolution of financial distress. Those countries need only provide a discharge more promptly, lower requirements for post-bankruptcy payments, or increase the level of exempt assets. Conversely, legislators concerned that spiralling filing rates reflect abuse should interpose obstacles to the discharge or increase the likelihood that filers will be obligated to make post-bankruptcy payments to their creditors.

B. Cultural Explanations

A second possibility recognises the interaction between the formal legal system and the society in which it is embedded. Cultural predispositions might affect the decision to file for bankruptcy, and those predispositions may differ from country to country. That perspective recognises that the decision to file for bankruptcy is a permanent one that will have lifelong consequences for the individual that makes it. Hence, if this explanation were important, filing decisions should diverge from those predicted by a rational-actor conception of the bankruptcy decision: individuals might refrain from filing for irrational ‘emotional’


\(^{19}\) See White, ‘Why It Pays to File’, above n 18.
reasons even if the benefits available to them from a bankruptcy filing exceeded the out-of-pocket costs connected with the filing.

Cultural attitudes about bankruptcy also should affect the legal system itself. Iain Ramsay reminds us that legislators adopt laws that reflect the cultural dispositions that prevail among their constituents and the interest groups that are influential in their jurisdiction. For example, UK leaders could embrace bankruptcy reform because of a ‘strong admiration’ for a ‘vibrant enterprise culture’ that involved ‘responsible risk taking.’ At the same time, concerns that relief for non-business debtors was an entirely different matter made it important for the Government to emphasise its opposition to ‘a safety net for overindebted consumers.’ In this vein, Rafael Efrat argues that cultural attitudes about entrepreneurs explain a great deal of the variation in the formal legal systems for consumer bankruptcy.

Although those types of effects are difficult to measure directly, proxies might shed light on the differing levels of cultural resistance to bankruptcy in different nations. In the existing literature, for example, cultural explanations gain powerful empirical support from data about United States filings. Specifically, Michelle White’s work indicates that about 15 per cent of all households would benefit in economic terms from filing for bankruptcy, but only about 1 per cent file for bankruptcy in any given year. The size of the gap suggests that the rational-actor conception captures little of the motivations for filing; it is reasonable to infer that a portion of the gap is attributable to cultural resistance to bankruptcy filing.

Although there is a long tradition of designing social programs in a way that stigmatises their use, it is not clear how often legislators succeed. The mere existence of a national bankruptcy system legitimates bankruptcy filing to a considerable degree. Similarly, high levels of overindebtedness are likely to create a culture in which bankruptcy filing necessarily becomes more culturally acceptable. As more individuals use a bankruptcy system to resolve their financial problems and move forward with their lives, a larger and larger share

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21 Ibid at 17–18.

22 Ibid at 18.


26 The distinction from welfare is instructive, where stigmatised public assistance programs can be relegated to local authorities. The commitment to a bankruptcy system, by contrast, occurs at the national level. Interestingly, to the extent the United States system has delegated authority to the local standing Chapter 13 trustees, a case can be made that the result has been ‘local legal culture’ that in some locales stigmatises Chapter 7 bankruptcy filings. See T Sullivan et al., ‘The Persistence of Local Legal Culture: Twenty Years of Evidence from the Federal Bankruptcy Courts’ (1994) 17 Harvard Journal Law Public Policy 801.

of the populace will be acquainted with people for whom that choice turned out to be a good one. This in turn will weaken norms that regard bankrupts as an ‘other’ class of people held in general disdain. Moreover, as suggested above, cultural predispositions motivate legislatures as well. Thus, in a society in which compassion for bankrupts becomes widespread, it may become increasingly difficult for legislators to treat bankrupts harshly.

C. Economic Explanations

The final possibility resonates with the opening paragraphs of this paper, connecting the increase in financial distress and bankruptcy filings to the rapid increase in consumer debt (and especially credit card debt) in most developed countries. The premise of this explanation is that bankruptcy filings for the most part are the result of exogenous shocks, which result in financial distress that would lead to filings in most cases without regard to legal or cultural factors.

If this explanation were important, the most significant predictors of nation-level filing rates would be consumer debt, credit card debt, and general economic conditions. Again, United States data support this theory. It is striking that the United States for years has experienced both the highest level of credit card debt in the world and the highest bankruptcy filing rate. Econometric models that scholars have used to illustrate connections between rising debt levels and increased filing rates buttress that intuition.28

Economic explanations would support intervention in the consumer credit markets. For example, a jurisdiction concerned about excessive insolvency might adopt regulations that limited the profitability of lending to those in severe financial distress, hoping to truncate that lending without undue distortion of the payment system or the broader lending market.29

III. ECONOMIC AND NON-ECONOMIC EFFECTS ON FILING RATES

The starting point in empirical analysis of consumer bankruptcy systems is the wide disparity in filing rates across national borders. Figure 11.1 illustrates the magnitude of the disparity, setting out the number of filings per million of population in each of five countries as of 2004 (the last year for which complete data is available). Figure 11.1 provides two data points for each country. The first number is the total number of all insolvency filings, which includes both the number of liquidation or ‘straight’ bankruptcy filings and also the applicable systems for ‘rehabilitations’ or ‘proposals’ or ‘plans’.30 Each of the five countries

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28 See Mann, above n 7, at 45–72 (summarising and extending that literature).
29 Ibid at 119–206 (detailed proposals for intervention in consumer credit markets in the US).
30 The Appendix includes a more complete set of charts showing a time series of those filings for each country from 1990 to the present.
has both types of system. The second number reports only the number of liquidation or straight ‘bankruptcy’ filings.31

In isolation, Figure 11.1 suggests that the US has by far the highest rate of filing, with steadily decreasing filing rates in Canada, Japan, Australia, and the UK. Although the disparity is striking, it should be clear from the discussion above that the raw numbers say little about the cause of the disparity. Without further information, it is impossible to tell whether the disparity relates to differences in the systems themselves or rather to cultural differences or differences in economic conditions.

As it happens, it is possible to identify the economic factors that affect the level of insolvency filings in a particular jurisdiction. In prior work focused on the relation between credit card debt and financial distress, I developed a model that documents a strong and significant relation between changes in the level of credit card debt and changes in bankruptcy filings. The model used credit card debt, credit card spending, total consumer debt, and unemployment (as independent variables) to explain the number of bankruptcy filings (as the dependent variable). Generally, the data suggest, an increase of $100 in credit card debt per capita will be followed one year later by an increase in bankruptcy filings of about 200 per million of population.32 As the magnitude of the filing rates in Figure 11.1 illustrates, that effect is large enough to have substantial practical significance.

Figure 11.1 2004 Insolvencies per million of population

31 As Figure 11.1 illustrates, including or omitting rehabilitation filings does not alter the relative number of filings for any country. However, in the United States there is a much higher percentage of rehabilitation filings than in other countries. The more common use of the rehabilitation system in the US may be attributed in part to the maturity of the Chapter 13 system and in part to the value of that system for retaining home and automobile ownership. In none of the other countries in my study would the rehabilitation filing interfere with the ability of a lender to pursue collateral such as a home or automobile.

32 See Mann, above n 7, ch 5.
As I worked with the data I began to explore how the effect differed from country to country. Even when I added variables (country dummies) to isolate country-specific effects, however, the relation between credit card debt and bankruptcy filings remained significant. What led me to this project was the surprising finding that the US was not at the top of the scale. Specifically, controlling for economic conditions, the coefficient on the United States variable did not suggest that there is a higher propensity to file in the United States than in the other countries. Intrigued by that finding, for this project I updated the data used in that work (to reflect additional years of filings) and also segregated the data to permit separate analysis of liquidation filings, rehabilitation filings, and total filings. My intuition was that data about liquidation filings might be more useful than data about total filings, at least in part because rehabilitation filings in many countries are more closely related to informal or voluntary resolution schemes. Moreover, stark differences in the relation between rehabilitation filings and secured credit suggest that those filings might be used for such different purposes in different countries as to make cross-border comparisons meaningless. Ultimately, the central inquiry should relate to total filings in countries (like the United States) in which the big step is to seek any type of formal insolvency relief. By contrast, in countries in which a rehabilitation filing is culturally and legally less significant (Japan, for example), it would be better to examine the smaller number of people that take the more complete step of filing a ‘straight’ or liquidation bankruptcy. The tables and regression analysis in this Chapter consider both metrics.

As summarised in Table 11.1, Canada moves to the top of the list once the credit-related variables are accounted for, at least for total filings and liquidation filings. Table 11.1 reports whether the filing rates per million are higher or lower than Canada, when economic conditions are controlled. Table 11.A1 in the Appendix includes more detailed data.

As the more detailed information in the Appendix shows more fully, large standard errors suggest that the estimates of the coefficients on the country dummies are relatively imprecise. The relations are statistically significant only for the United States and for Australia, and in Australia only for liquidation filings. Still, the pattern of negative coefficients is striking: the coefficients are negative for each country’s total filing propensity and its liquidation filing propensity, when they are compared to Canada. This suggests that, faced with

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33 A Chapter 13 filing in the US is commonly used to prevent a foreclosure on a home or repossession of an automobile. In none of the other countries in this study would a rehabilitation filing bring with it an automatic stay that would grant that protection. This differential benefit from a Chapter 13 filing is a good explanation for why the rate of rehabilitation filings in the US is significantly higher than the rate in Canada, although the rates of liquidation and total filings are higher in Canada than in the US.

34 Although Table 11.1 does not report it, the results confirm and extend the analysis reported in R Mann, Charging Ahead, above n 7, because credit card debt remains highly significant with a substantial positive coefficient in all of the different runs, generally significant at a .001 level.

35 Minus signs indicate a negative coefficient; plus signs indicate a positive coefficient. ** indicates significance at the 1 per cent level, * at the 5 per cent level, and # at the 10 per cent level. Table 11.A1 in the Appendix includes more detailed information about the regressions.
similar patterns of debt and unemployment, the bankruptcy filing rate would be higher in Canada than in any of the other countries. To put it another way, the data suggest that the high filing rate of the US is largely attributable to the economic conditions captured in the model. Once we control for those conditions, the US gives way to Canada as the nation with the highest propensity to file.

This presents a new puzzle for analysis: why, holding economic conditions equal, Canada should have such a higher ‘propensity’ to file than the USA and Australia. For convenience of exposition, the remainder of the Chapter uses the term ‘propensity’ to reflect this analysis—the extent to which the per capita filing rate in a country is affected by variables other than economic conditions. The next Part of the Chapter explores that puzzle.

IV. THE PATTERN OF INDIVIDUAL BANKRUPTCY FILINGS

The object of this Part is to resolve the two puzzles most clearly suggested by Table 11.1: why Canada’s propensity to file is so much higher than that of the United States and Australia. Because the cultural factors are harder to quantify, this Part begins by identifying features of the legal systems that are likely to explain the disparities set out in Table 11.1. The discussion generally rests on three hypotheses. First, the ease or speed of ‘back-end’ legal factors like the discharge is not useful in explaining filing rates. Second, the legal factors with the largest effect on filing rates are ‘front-end’ factors such as the procedural barriers or obstacles to filing; this factor is central to explaining the difference between Canada and the US. Third, where no pattern of legal differences

<table>
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</tr>
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<td>—</td>
<td>+</td>
</tr>
<tr>
<td>N</td>
<td>51</td>
<td>69</td>
<td>51</td>
</tr>
<tr>
<td>R2</td>
<td>.93</td>
<td>.93</td>
<td>.97</td>
</tr>
</tbody>
</table>

36 It would be surprising if the model did capture all of the variation because there have been substantial bankruptcy reforms in several of the countries during the period of the study. As discussed above, n 16, problems with the UK and Japanese data make it easy to see why the model does not produce significant results for those variables.

37 Given the ambiguity of the findings related to the UK and Japan, I leave that subject to another day.

38 For a similar argument about German filing rates, see W Backert et al, ‘Consumer Bankruptcy in Germany’, in Consumer Credit, Over-Indebtedness and Bankruptcy: National and International Dimensions, above n 5.
appears, it is reasonable to consider whether the residual cause is a strong cultural predisposition.

A. Why Is the Canadian Propensity to File Higher than the US Propensity?

The most intriguing problem is to explain the disparity in filing propensity between Canada and the US. Examining the two countries’ systems at a very high level of generality, they provide a good empirical test of the hypotheses about front-end and back-end factors. First, the US discharge is considerably more generous than the Canadian discharge, which would support a lower Canadian filing propensity if the terms of discharge were the most important factor. Conversely, the Canadian bankruptcy process is relatively more accessible than the American process, which would support a higher Canadian filing propensity if accessibility were the most important factor. My conclusion is that the data support the hypothesis that accessibility is a more important predictor of propensity than the generosity of the discharge. Canada has a greater propensity to file, once we account for the markedly higher level of credit card debt in the United States, because Canada’s relatively accessible bankruptcy system discourages fewer filers than the relatively inaccessible US system.

On the first point, the United States system offers a faster and almost unconditional discharge, with a stay automatically effective upon filing and a discharge available in theory immediately and in practice after a few months. By contrast, Canada, like most countries, does not permit an immediate discharge. Rather, the discharge cannot be considered for nine months and often involves an unstructured judicial assessment of a report filed by the bankruptcy trustee. To be sure, challenges to discharge are infrequent, apparently affecting far less than one-fifth of the cases. Yet, the fact remains that the delay of the discharge

39 BAPCPA did introduce revisions that limit the automatic effectiveness of the stay, but those apply only to repeat filers. See 11 USC § 362(c) (3) (automatic stay against certain creditors lasts only 30 days for certain repeat filers) and (4) (no automatic stay for certain multiple repeat filers).

40 To be sure, the United States has more exceptions to discharge than the other countries I study. See WC Whitford, ‘Changing Definitions of Fresh Start in American Bankruptcy Law’ (1997) 20 Journal of Consumer Policy 179. But those exceptions seem to me back-end issues less likely to affect the decision to file.

41 Bankruptcy and Insolvency Act § 170, RSC 1985, c.B-3; S Ben-Ishai, ‘Discharge’ in S Ben-Ishai and A Duggan (eds), Canadian Bankruptcy and Insolvency Law 357, 358–60 (Markham, Lexis Nexis Canada, 2007); Duggan, above n 4, at 873–6. Similarly, the Canadian process includes rules under which debtors with substantial ‘surplus’ income must make periodic payments to their creditors. Apparently about one-fourth of Canadian debtors make such payments. Ibid at 864; S Ben-Ishai, ‘Means-Testing’ in Canadian Bankruptcy and Insolvency Law at 343, 353. Ben-Ishai emphasises that this leaves the system more accessible than the US system ‘because debtors with surplus income are still able to move through the bankruptcy process, they are not directly prevented from accessing the fresh start offered by a liquidation bankruptcy or forced into an enforced payment plan.’ Ibid at 355.

and the risk that it will not be granted unconditionally are quite different from the US experience, where objections to discharge are rare.

On the other hand, the procedures for instituting a bankruptcy in Canada are much simpler than the United States procedures. The prospective bankrupt initiates the proceeding by filing a simple standard-form assignment. The fee is CAN$75 for summary administration (cases with less than $10,000 in assets, more than 90 per cent of all cases) and CAN$150 for regular administration. The typical consumer bankrupt does not retain an attorney, though it must pay the fees of the trustee. There is no mandatory examination by creditors, and no ‘abuse’ provision that might force the debtor to use the alternative ‘proposal’ system. There is a mandatory counselling requirement (introduced in 1992), but it occurs after the filing, not before. In the United States, the process is much more cumbersome. The forms are considerably more complex, and BAPCPA has only made them more so. Indeed, it is clear that the timing of bankruptcy filings is affected to a considerable extent by the need to collect the information necessary to complete the requisite forms. Thus, although there is no legal requirement that filers retain an attorney or trustee, the overwhelming majority choose to do so.

The juxtaposition of those distinctions with the substantial difference in propensity to file provides powerful support for the hypotheses about legal pre-cursors. If the economic features of the discharge and future income payments—the ‘back-end’ effects of bankruptcy—were an important precursor of a high propensity to file, then it is surprising that there is a relatively high propensity to file in Canada. Conversely, the difference between Canada’s streamlined procedures and the burdensome procedural obstacles in the United States cuts in the same direction as the propensity data presented in Part III.

B. Why Is the Canadian Propensity to File Higher than the Australian?

The second puzzle is how to distinguish Australia from Canada. As Part III illustrates, Australia has a lower propensity to file after accounting for economic

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43 Ziegel, above n 4, at 19.
44 Bankruptcy and Insolvency Act § 132, RSC 1985, c.B-3; Duggan, above n 4, at 870.
45 Ziegel, above n 4, at 18. It is difficult to generalise about the levels of Canadian trustee fees, which in some cases might approximate the fees of US attorneys. See below, n 49.
46 Ziegel, above n 4, at 20–1.
48 This also has become more significant after BAPCPA. R Mann and K Porter ‘Saving up for Bankruptcy’ (forthcoming 2010) 98 Georgetown Law Journal (Section V (c)).
49 Interestingly, it is not clear that the out-of-pocket costs of filing differ substantially in the two countries. Although the US filing fees are much lower, the costs of trustees in Canada well might exceed the costs of attorneys in the US. At the same time, it appears that US attorneys are much more likely to require up-front payment than Canadian trustees. J Ziegel, ‘Indigent Debtors and Financial Accessibility of Consumer Insolvency Regimes’, in JP Sarra (ed), Annual Review of Insolvency Law (Toronto, Thomson Canada Limited, 2005) 500–4.
conditions. The next question is whether legal or cultural factors can explain the difference.

i. The Failure of Legal Explanations

As other scholars have noted, it is difficult to discern credible explanations based on the bankruptcy systems themselves. First, the ‘back-end’ portions of those systems are quite similar. For example, the Australian discharge (historically available after 12 months of surplus income payments) closely resembles the Canadian discharge available after nine months. Because Australia’s propensity to file is so much lower than Canada’s, it is hard to put much weight on the discharge as an explanation. Nor do procedural obstacles offer anything to explain the distinction. Australia’s system for initiating bankruptcies is for the most part quite similar to that of Canada; if anything it appears to be more accessible than Canada’s, not less. Professor Ziegel explains, ‘the important point worth stressing here is that it is even easier—and certainly much cheaper—for Australian debtors to initiate bankruptcy proceedings than

50 See authorities cited above, n 4.
51 Surplus income payments are even less common in Australia than in Canada. See J Braucher, ‘A Comparative Study of Repayment Forms of Individual Bankruptcy’ in J Niemi-Kiesiläinen et al, Consumer Credit, Over-Indebtedness and Bankruptcy: National and International Dimensions, above n 5 (reporting a substantial increase in payments, up to 12 per cent of all filings, as compared to more than 20 per cent of filings in Canada).
52 Australia’s discharge period was lengthened to three years in 2002. See Duggan, above n 4, at 877. But Australian rates were much lower than Canada’s even before that change. Moreover, as Figure 11.A1 illustrates, the slight (and apparently temporary) decline in filings after 2002 is a small fraction of the aggregate difference between Canadian and Australian filing rates.
53 Recent Japanese reforms (intended to encourage bankruptcy filings) suggest that the nature of the discharge is similarly unimportant in explaining the low Japanese filing rate. See J Matsushita, ‘Comprehensive Reform of Japanese Personal Insolvency Law’ (2006) 7 Journal of Theoretical Inquiries Law 555, 560–4 (summarising those reforms). Although it is too early to be sure (because of the slow process Japan follows for issuing bankruptcy statistics), the early evidence—a substantial decline in 2005 bankruptcy filings—at least suggests that these reforms will solve little of Japan’s problem. To be sure, the improvement in Japan’s economy beginning in 2004 might have caused some of that decline. However, an obvious alternative hypothesis supported by the experience in other countries is that the 2004 reforms—which emphasize increasing exempt assets and broadening the discharge—do little to address the heart of what keeps Japan’s filings low: the expensive and cumbersome process for gaining access to bankruptcy.
55 Ziegel repeatedly notes the difference in filing rates, but does not undertake to explain it. Ziegel, above n 4, at 94, 106.
it is for a Canadian debtor. For example, a bankrupt commences a case by completing a short standard form of assignment. The only substantive filing requirement is that the debtor be insolvent. Australia offers a summary administration process with no creditors’ meeting for cases with less than $10,000 in assets (which applies to about 90 per cent of Australian cases). Moreover, debtors typically do not use attorneys or private trustees; rather the Official Trustee administers the case, collecting its fee from the estate and relying on a public subsidy to administer no-asset cases.

ii. Cultural Explanations

If neither economic explanations nor legal explanations are fruitful, an obvious possibility is that cultural explanations provide an explanation for the observed pattern. Because cross-border cultural explanations are inherently nebulous (like dark matter), any such explanation necessarily is speculative. That is particularly true here, where the cultural factors would have to be remarkably powerful to explain the disparities identified in Figure 11.1 and Table 11.1. Still, the juxtaposition of nearly identical legal systems and similar economic conditions with starkly different filing rates justifies exploration of the possibility.

One objective place to look for indicators of a strong cultural disposition against bankruptcy is statutes that impose substantial legal disabilities on those who file for bankruptcy. Such statutes could persist only in a society with a strong cultural disposition against bankruptcy. Here, there is some evidence to suggest that Australian society takes a harsher perspective than Canada. In contrast to Canadian law, which imposes no substantial disabilities, Australian bankrupts forfeit their passports when they file.

One intriguing suggestion comes from Iain Ramsay, who argues that we observe high filing rates in countries (like Canada and the US) in which private professionals assist bankrupts in initiating proceedings because those professionals have an economic incentive to raise awareness of the bankruptcy process. By contrast, Ramsay argues, we observe low filing rates in countries (like Australia and the UK) that rely entirely on public officers to assist filers, because those officers have a significantly lower incentive to publicise the

56 Ziegel, above n 4, at 96–7. Tony Duggan and Jean Braucher share Ziegel’s perspective. Duggan, above n 4, at 869–72; Braucher, above n 51.


58 The UK provides a startling example. Until the Enterprise Act reforms in 2004, the UK bankrupt was subject to numerous serious civil disabilities, akin to those typically imposed on felons. Among other things, British bankrupts (at least before the 2002 Enterprise Act became effective in 2004) could not be a Member of Parliament, Justice of the Peace, company director, chairman of a land tribunal, school governor, estate agent, charity trustee, or even a practicing solicitor or insolvency practitioner. See A Walters, ‘Personal Insolvency Law After the Enterprise Act: An Appraisal’ (2005) 5 Journal of Corporate Law Studies 65, 82–3.

59 Bankruptcy Act 1966 § 272. See Duggan, above n 4, at 892. It is unclear how important this ban is in practice. Apparently Australians usually can travel abroad after seeking permission from the trustee. Still, the formal requirement is quite stigmatising.
process.\textsuperscript{60} It is difficult to evaluate that perspective as an overarching explanation. For example, given the low esteem for lawyers and the legal process in the US, many would regard the practical need for lawyers in the US bankruptcy process as an obstacle. A purely administrative process might in practice be much more accessible.

On the other hand, I take Ramsay’s central point to be that the private professionals are central in increasing public awareness and receptivity to the bankruptcy process. Even in the US advertising by lawyers appears to play a role in developing a cultural perception of bankruptcy as a routine solution to financial distress.\textsuperscript{61} If that is the significance of private professionals, then it is hard to be sure that their appearance is not an effect of a relatively receptive culture rather than a cause. In either case, Ramsay’s thesis is consistent with the pattern I identify here.\textsuperscript{62}

C. Summary

In a way, the central puzzle the data presents is why Canada’s propensity to file is so high, given relatively low levels of debt. One possibility could be that Canadian debt is riskier or more perilous in some way that aggregate data cannot reveal, so that the same level of credit card and other borrowings in Canada would result in higher bankruptcy filings than in other countries. However, the best evidence about global credit card markets makes that hypothesis implausible. If anything, Canada’s use of payment cards appears to be considerably more benign than the use in the United States and Australia.\textsuperscript{63} That suggests that we must look to legal or cultural explanations. With respect to the United States, the most salient distinction that would explain a relatively higher propensity to file is Canada’s decision to make its bankruptcy system so accessible, particularly for those in more desperate condition. With respect to Australia, distinctions are even more elusive because it is difficult to identify any feature of the legal system that makes Canada’s bankruptcy system more accessible than Australia’s. Recognising that the inquiry is speculative, it does suggest that cultural predispositions against bankruptcy are remarkably stronger in Australia than in Canada, reinforced by the greater presence of marketing and advertising in Canada.

\textsuperscript{60} Ramsay, above n 3. See Duggan, above n 4, at 893 (tentative endorsement of Ramsay’s hypothesis).

\textsuperscript{61} That certainly is something for which consumer bankruptcy lawyers routinely are criticised. See RJ Mann, ‘Bankruptcy Reform and the “Sweat Box” of Credit Card Debt’ (2007) Illinois Law Review 375, 375.

\textsuperscript{62} As Tony Duggan has pointed out to me, Ramsay’s thesis leaves unexplained why a culture that is by hypothesis so opposed to bankruptcy would embrace a legal system that on its face is so receptive to bankruptcy. One obvious possibility is that Australia tolerated such a system because filing rates remained low. When filing rates rose in the late 1990s to levels that were remarkably high by Australian standards (though still far below typical rates for the US and Canada), Australia responded by restricting the relief available to those that file. As suggested above n 52, it is not yet clear that those reforms will have a permanent or substantial effect on filing rates.

\textsuperscript{63} Compared to the US market, Canada’s use of debit cards is much more common and its level of borrowing in payments transactions is much lower. See Mann, above n 7, chs 9–10.
V. POLICY IMPLICATIONS

The analysis in Parts III and IV is descriptive, an attempt to understand the causal relationships between institutional precursors of individual bankruptcy filings and the different filing rates we observe around the world. That discussion, however, does have normative significance. By exposing the reasons for the different rates, it explicates the social impact of existing legal systems as well as the potential gains (and losses) from reforms. Because the focus of this project is the legal systems for consumer bankruptcy, this Part of the Chapter emphasises the legal explanations rather than the cultural explanations.64

If we set cultural explanations to the side, the most important conclusion in Part IV is that nation-level filing rates depend much more on front-end procedural obstacles to filing than they do on back-end issues about the timing and conditions of a final discharge. This was surprising at first, because it is in considerable tension with the conventional understanding that high filings plague the US system because of its undue laxity. Yet on reflection, two points make this finding easier to accept.

The first is a behavioural point, that the typical potential bankrupt will pay more attention to those parts of the legal system that are more immediate and less to those that will not have direct effects until weeks or months after a bankruptcy filing. The typical client will be more concerned about the detailed financial records to be produced and the $700–$1,000 to be paid up front, than about the lawyer’s estimation of the amount of debt that will still be owed months or years later when the proceeding is finally concluded. This distinction is implicit in my characterisation throughout this Chapter of procedural obstacles as front-end attributes and discharge and payment issues as back-end attributes. The individual’s reaction to the immediate and remote attributes of the bankruptcy process differs little from the individual’s reaction to the immediate and remote attributes of complex products like cell phones, health clubs, and credit cards.65

The second relates to the attributes of the universe of potential bankrupts. Rules about income payments and conditions of discharge have relatively little significance for those who have no income or assets, because whatever the law says they are unlikely in fact to make substantial payments to creditors or to suffer in a material way from post-bankruptcy collection activity. Those issues matter, rather, to the relatively well-off subset of filers for whom future payment obligations are realistic. Conversely, procedural obstacles will matter the most

64 I have argued in prior work that it is a poor policy choice to influence bankruptcy filing rates by enhancing cultural predispositions against filing. Mann, above note 7, ch 13; RJ Mann, ‘Optimizing Consumer Credit Markets and Bankruptcy Policy’ (2006) 7 Journal of Theoretical Inquiries Law 353.

to those without income or assets. A $1,000 bill for costs and fees of filing a bankruptcy petition is much more likely to slow a filing by a desperate bankrupt with no income or assets than it is a filing by middle-class debtors with steady income but no realistic possibility of meeting their financial obligations. Moreover, the desperately insolvent have relatively little to gain from a bankruptcy filing (at least in an economic sense). They will pay little or nothing on their debts in any event. For them, the immediate gain from a bankruptcy filing comes from the possibility that creditors might harass them less after they file. The relatively well-off middle-class filers have the most to gain in economic terms, because the bankruptcy process allows them to protect assets or income from creditors who might be able to force payment absent a discharge in bankruptcy.

With respect to the US, the Consumer Bankruptcy Project shows that a great many of those who actually file have very little income and few assets. For example, as of 2001, the median household income of debtors in the Consumer Bankruptcy Project was only $20,172; 41 per cent were below the poverty line. Asset values are harder to judge, because about half of US bankrupts have homes. Considering non-real-estate assets (the only likely sources for distributions to creditors), the median value of assets was less than $10,000, far below the median value for all families (more than $40,000).

The Consumer Bankruptcy Project, however, does not say anything about how many more people, similarly desperate, are excluded from the system by the procedural obstacles discussed above. The best evidence of the size of that population will be evident whenever post-BAPCPA filing rates become sufficiently stable to allow us to discern the size of the decline attributable to that statute. Figure 11.A5 shows the total filings in the United States over time, with a data point for 2007 extrapolated from the data for the first half of 2007. As the figure suggests, the filing rate almost two years after the effective date of BAPCPA remains substantially below the filing rate before BAPCPA. Thus, although it is still too early to speculate on the ultimate size of the gap, it is increasingly clear that there will be some gap, that the post-BAPCPA filing rate will remain below the pre-BAPCPA filing rate for the foreseeable future. Because the most important provisions of BAPCPA that are likely to affect the filing rate are provisions designed to increase the procedural obstacles to bankruptcy, the size of that drop suggests the significance of this group to the total filing rate.

If marginal filers with no substantial assets or income are a large portion of the potential bankrupts, marginal filers also are those for whom there is the greatest divergence between the private and social value of the bankruptcy filing. As discussed above, the economic value of a bankruptcy filing for a debtor

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67 See ibid at 226–7.
68 For a detailed discussion of the various factors that affect the size and duration of that gap, see Mann, above n 61.
69 Ibid.
with little income and few assets is relatively small, because the debtor gains relatively little from the discharge. However, the net social value of the discharge is considerable. On the one hand, the discharge harms third parties relatively little, because even without a discharge creditors would collect little of their debts from this class of bankrupts. On the other hand, society gains considerably from the discharge, because it is central to redeployment of the debtor’s human capital. The premise of the bankruptcy discharge is that it increases the likelihood that the discharged can move forward with their lives, engaging in productive economic activity—jobs, tax payments, and attention to their family—and decreases the likelihood that they will drift into positively harmful activities—drug use, crime, and the like.70 The more a legal system can facilitate that redeployment, the greater the net social benefits from the system.71

Given the decades of experience that the US has had with its bankruptcy system, it is surprising that the US has not yet come to grips with the reality of the lower-middle-class bankrupt who has no substantial income or assets. Many other countries have rapidly developing and widely used systems for ‘no-income, no-asset’ or NINA filings. Thus, following the lead of New Zealand,72 the UK’s Insolvency Service has proposed a NINA Debt Relief Order designed to be a low cost alternative for ‘the very poorest’ individuals.73 Available to individuals with no more than £50 in surplus income and no more than £300 in realisable assets, the process would be entirely administrative and have a significantly lower filing fee than the standard bankruptcy process.74 The Insolvency Service estimates that filings under the NINA system would be at a rate of more than 500 per million per year, a substantial number in a nation that currently has only about 1,000 bankruptcy filings per year.75

Similarly, although Canada already has a ‘summary administration’ process with reduced fees and process, used by about 90 per cent of its debtors, Canada’s Personal Insolvency Task Force recently spent considerable effort debating an even more streamlined ‘fast track’ process for the poorest debtors.76 Sweden is

71 The concerns about the potential for positive spillover effects from the bankruptcy process that have so been absent from the US deliberations have dominated European debates in recent years. Eg, Kilborn, ‘Sweden’, above n 54, at 439; J Kilborn, ‘The Hidden Life of Consumer Bankruptcy Reform: Danger Signs for the New US Law From Unexpected Parallels in the Netherlands’ (2006) 39 Vanderbilt Journal of Transnational Law 77, 93 (hereinafter Kilborn, ‘Netherlands’).
73 Insolvency Service, Relief for the Indebted—An Alternative to Bankruptcy (March 2005); Insolvency Service, Relief for the Indebted—An Alternative to Bankruptcy: Summary of Responses and Government Reply (November 2005).
75 See ibid at 648–9.
76 Ziegel, above n 4, at 19. See also S Ben-Ishai and S Schwartz, ‘Bankruptcy for the Poor’ (2007) 45 Osgoode Hall Law Journal (estimating that 70–80 per cent of Canadian failures would qualify as NINA filers). Despite the protracted consideration, the task force ultimately made no recommendation on the question, which remains unaddressed in Canadian law. See Duggan, above n 4, at 872–3.
implementing this year major reforms designed to truncate the process to speed the return of the insolvent to economic productivity. Recent Netherlands reforms include a ‘fast-track’ procedure for ‘extreme’ cases in which neither assets nor income are expected to produce a return to creditors. Although administrators are applying the procedure cautiously ‘to create societal support’ for the new law in its early years, it appears that creditors receive distributions in no more than a fifth of all cases in the Netherlands. Despite the vehement German objections to an American-style discharge, German legislators finally recognised the need for a reduced-cost procedure for no-asset cases, a procedure that has received a major share of filings since its introduction in 2001. Similarly, recognising that French courts were ‘literally submerged by the flood of overindebtedness cases,’ French legislators in the 1990s largely removed any judicial role in most cases. More recently, French legislators adopted a new procedure for ‘personal recovery’ to deal with the large share of cases (about one-quarter of all filings) in which it is immediately obvious that there is no prospect for payments to creditors.

These systems recognise that the appropriate bankruptcy procedure for this slice of the debtor population, what we might call the low-income, low-asset (LILA) debtors, is a purely administrative process. For individuals that cannot reasonably be expected to make any substantial payments, processing at the lowest possible transaction costs should be the goal. The US, by contrast, continues to use a ‘one size fits all’ system, with procedural obstacles that are wastefully obstructive for much of the bankrupt population.

The evidence points toward bankruptcy simplification. The time has come to abandon the complicated structures laden with bureaucratic hurdles and special-interest provisions worthy of the Internal Revenue Code. At least for the desperately insolvent, with no substantial income or assets, the best process is one that is stripped down to its most central elements. First, the system should function as

81 See ibid at 655–61.
82 I am reluctant to proliferate acronyms but the NINA terminology is highly misleading, because the filings are not limited to those with no income or assets at all, but rather to those who have no substantial income or assets. It is also unfortunately confusing that the same term has come into common use to describe no-document real-estate mortgages in the sub-prime sector in recent years.
83 For parallel arguments, see J Braucher, ‘A Fresh Start for Personal Bankruptcy Reform: The Need for Simplification and a Single Portal’ (2006) 55 American University Law Review 1295; Kilborn, above n 2. I note that this discussion does not consider the likelihood that debtors often have broader social problems (patterns of drug abuse, dysfunctional family lives, etc), and that the bankruptcy process might be an ideal opportunity to respond to them. As noted by commenters at the Berlin conference for which this Chapter was prepared, European insolvency reform has taken that problem much more seriously than American reform has.
an administrative process designed to provide a service at the lowest possible transaction cost rather than as an adversarial judicial process. In cases with low levels of assets and income there should be few important factual disputes; disputes about the amount of claims and priorities among creditors are important only when there is valuable collateral or non-exempt assets. Judicial staff and attorneys in the US already work hard to process these cases economically, but the excessive requirements of the post-BAPCPA process waste social resources.

Second, the system should provide complete and unconditional relief as quickly as is practicable. This should occur within days or weeks after the filing, not months or years. Again, when the debtor has low levels of income and assets, delaying or conditioning the discharge only delays the return of the debtor to productive economic activity unburdened by the overhang from the debts of the past.

Finally, the system should impose stern criminal sanctions for fraud, with adequate resources to ensure prosecutorial vigilance. A simple and expedient process will collapse if it is tainted by fraud. Among other things, the cultural perception of those who have gone through the process will turn negative, making it harder to persuade the ‘honest but unfortunate’ debtor to take advantage of the process. The simplest way to avoid that problem is with an oversight system that imposes sufficiently severe penalties on abusive filers. If we want to make a cultural point, the point to be made is that abuse of the system cannot be condoned. An effort to extend that condemnation to the hopelessly insolvent, by contrast, helps none of us.

APPENDIX

Figure 11.A1 Australian insolvencies over time

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Figure 11.A2 Canadian insolvencies over time

Figure 11.A3 Japanese insolvencies over time
Figure 11.A4 UK insolvencies over time

Figure 11.A5 United States insolvencies over time
Table 11.A1 Summary of regression model

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<td>-4.69**</td>
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</tr>
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<td>.93</td>
<td>.93</td>
<td>.97</td>
</tr>
<tr>
<td>N</td>
<td>51</td>
<td>69</td>
<td>51</td>
</tr>
</tbody>
</table>

#—significant at .1 level
*—significant at .05 level
**—significant at .01 level
***—significant at .001 level

The table reports the coefficient, the robust standard error in parentheses, and the t-statistic below. The coefficients are in filings/million. Canada is the omitted case, so the coefficients indicate the extent to which filing rates under the same conditions would fall short of (or in the case of rehabilitation filings, exceed) Canadian rates. The regressions use robust clusters to control for autocorrelation in the time series.
Overindebtedness and Financial Stress: A Comparative Study in Europe*

CATARINA FRADE AND CLAUDIA ABREU LOPES

I. INTRODUCTION

IN BROAD TERMS, overindebtedness refers to situations in which families are unable to pay one or more debts out of their disposable income when they become due. Further to the psychological discomfort that overindebtedness entails, the problem may potentially lead to social, financial and market exclusion. In extreme cases, divorce, mental disorders, homelessness or even suicide may be directly related to prolonged stress and anxiety caused by overindebtedness.

Theoretically, the disposable income of a household may be split into two different parts: a pre-committed part, used to meet households’ basic needs and credit repayments, and a remaining part that may used for supplementary consumption and/or saving. In times of financial hardship, efficiently managing the flexible part of one’s income is the most straightforward way to avoid stress. Considering no external financial aid, the size of savings and the possibility of dropping certain consumptions will determine whether the household has the necessary resources to keep paying its debts on time. Problems arise when the flexible portion of a family’s income is non-existent or very small, or else when it is substantial, but the family resists altering its patterns of consumption. The

* The research for this Chapter was funded by the Portuguese Science and Technology Foundation (Project ID: POCTI/JUR/40069/2001).

1 ASB, Overindebtedness as a Barrier to Labour Market Access in Europe. Challenges and Ways Forward (Salzburg, ASB Schuldnerberatungen GmbH, 2004); C. Frade, A regulação do sobreendividamento (PhD dissertation) (Coimbra: Faculdade de Economia da Universidade de Coimbra, 2007).

odds that a household will be pushed into overindebtedness are then substantially increased. Thus, a variety of overindebtedness scenarios may exist.

The financial equilibrium between disposable income and consumption may be disrupted in a number of ways: by a decline in total income, for example, due to family breakdown or unemployment, or by the sudden rise of expenses due, for example, to unanticipated health costs or when a household debt burden increases due to a rise in interest rates. In such situations, the total income retained for debts and basic consumptions tends to remains unchanged, and so efficient management is required to equilibrate the household’s finances. Savings or extra earnings (for example, self-employment, financial help from others) and social welfare (unemployment benefit, pensions, minimal income benefit), can be used to compensate for the loss of total or part of income and/or rise of expenses. When these solutions are insufficient or not available, the only way to avoid a financial crisis is to adjust consumption patterns.

The propensity of a household to be trapped into financial scenarios may be associated with a range of factors, some attributable to individuals, such as education level (for example, a lower education level is more associated with unemployment), and others related to household composition (for example, a drop in income will have more impact on a single parent), socio-cultural characteristics (for example, some cultures favour borrowing) or even the economic dynamics of a country (for example, inflation rate, social expenditure cuts). Taking as an example a drop in the total income due to job loss, one might suppose that the unemployment rate of a country has an effect on the likelihood of the occurrence of overindebtedness. However, within a country, certain risk groups may also be more prone to unemployment (lower qualifications, particular age groups, etc). With regard to the increase in expenses, the country’s inflation rate and economic oscillations may also have an impact on the frequency and extent to which people experience financial shocks. However, one can also expect that younger families, especially those with children, are more exposed to variations in household expenses. Adverse macroeconomic circumstances will then make life much harder for those who are already struggling to manage their finances.

This study represents a first attempt to analyse empirically, and cross-nationally, some macroeconomic conditions that may frame overindebtedness. It may be understood as an empirical exercise that relies on rigorous cross-national data pertaining to household financial conditions as well as macroeconomic statistics. We will focus on a limited set of characteristics that shape the likelihood that families will experience financial stress, such as economic activity, availability of borrowing, unemployment rate and income inequality. We will then analyse the impact of these macroeconomic variables on individual financial perceptions, taking into account different national socio-cultural contexts.
II. CAUSES OF OVERINDEBTEDNESS

The causes of overindebtedness have traditionally been viewed from two distinct perspectives, as pointed out by Braucher. On the one hand, structural factors, such as the deregulation of the credit market, the democratisation of credit and insecurity in family finances, coupled with an insufficient social safety net, were considered valid explanations for the emergence and spiralling of overindebtedness. On the other hand, cultural factors also have a role to play. A culture favourable to excessive consumption and borrowing has been underlined in discourses that blame consumers’ irresponsibility, lack of knowledge or even cognitive inability to manage personal finances. A more lenient perspective has also been stressed by others focused mainly on psychological explanations such as cognitive distortions, human values, attitudes and risk perception towards consumption and credit.

As far as prevention of overindebtedness is concerned, the distinction between its structural and cultural causes is rather artificial since cultural attitudes to spending are largely dependent on the structure of the credit system. In this context, it is not reasonable to think of cultural transformations independently of structural changes. Initiatives designed to create a culture of saving and responsible credit, for example, would have only a marginal impact if structural forces were operating in the opposite direction. As Braucher puts it:

programs and policies designed to change consumer culture to reduce risk of debt problems will have a hard time succeeding when pitted against aggressive marketing of goods, services and high cost credit.

By the same token, a visible transformation in credit culture does not occur directly as a result of the establishment of new policies. Such a transformation presupposes an extensive mechanism of socio-cognitive adjustment to the new ideas in people’s minds, in which psychological processes intervene, such as the information’s diffusion and management, cognitive assimilation and accommodation, and feedback loops based on consumers’ actual experiences and

8 See Braucher, above n 3, at 3.
expectations. A gradual change would emerge from the dialogue between innovative ideas and existing collective attitudes, systems of beliefs and values embedded in a culture. Therefore the cultural milieu is a fundamental determinant of whether a new input will succeed or fail. Along these lines, cultural variations in consumer behaviour and attitudes toward credit and borrowing are expected to occur in countries with similar structural conditions.

A range of studies have examined the effect of structural and socio-individual factors in the consolidation of financial hardship. Most of these studies are based on consumer survey data (for example the Family Expenditure Survey in the UK, Einkommens- und Verbrauchs-Stichprobe in Germany and the Household Budget Survey in Ireland), credit records (for example Central Credit Registration in Germany) or consumer defence associations listings (for example the Citizens Advice Bureau in England and Wales and the Consumers Defence Association in Portugal).

When the nature of overindebtedness in different countries is analysed, unemployment turns out to be a major determinant of default and overindebtedness. This is the case, for example, in Austria, Belgium, Germany, France, the UK and Portugal. However, certain socio-demographic characteristics have been identified as being associated with default and overindebtedness. Kempson et al found amongst UK consumers a positive relationship between the number of children and household default. This conclusion was reinforced by another study conducted in the UK by the Department of Trade and Industry, which showed that younger consumers (age group of 20 to 30 years) with children and low income are overrepresented amongst overindebted consumers. In turn, Woods found a higher prevalence of overindebtedness in the age group of 25 to 49 years, married, with children and low income, for Northern Ireland. In Germany, Haas observed that overindebtedness was triggered by the com-


12 See C Frade and C Lopes, above n 6.


15 M Woods, Personal Over-Indebtedness in Northern Ireland (Belfast, Office of the First Minister and Deputy First Minister, 2006).

16 Haas, above n 10.
tion of a low income and a high debt burden. Non-intact families are a critical group, overrepresented in the overindebted population. In New Zealand, Valins reported that younger individuals and people with lower education levels are more likely to be overindebted. In Portugal, a recent study carried out by the Observatory of Consumers’ Indebtedness came to the conclusion that Portuguese overindebted people are aged between 30 and 49 years, married, with children, low to middle educated and earning lower to middle incomes.

Taking these studies as a whole, an overall pattern emerges. Overindebtedness is more prevalent among the young, the less educated and those with children and low income. Nevertheless, these studies offer a rather segmented picture made by pieces of non-comparable information drawn from different countries. A remarkable exception to this scenario is a recent study by Gumy that utilised comparable objective and subjective measures for overindebtedness in 15 countries and that aimed to explain overindebtedness based on socio-demographic individual data, and countries’ legislative and welfare systems, aggregated into four clusters: corporatist, socio-democratic, liberal and southern. However, Gumy failed to examine the particular macroeconomic characteristics that are associated with overindebtedness.

III. MEASURES OF OVERINDEBTEDNESS

A common limitation that encompasses the empirical study of overindebtedness is related to the lack of a consensual formal definition for the concept. There is no agreement in the literature about such a universal definition and respective measure. In the above-mentioned examples, various approaches have been proposed in different studies dealing with particular national realities, making the direct comparison of the results unfeasible.

Several problems arise if we rely on objective indicators of overindebtedness, such as debt-to-income ratio, debt-to-assets ratio, debt-to-savings ratio and debt-to-service ratio, in a specific period of time (economic indicators), or court arranged solutions to debt, repayment plans or debt write-offs by creditors (judicial/administrative indicators). In the first place, it is not possible to set up universal minimum accepted standards of living. Economic, social and cultural factors play an important role in considerations of what is reasonable in a particular society. Secondly, a high debt burden does not inevitably lead to

18 See C Frade and C Lopes, above n 6.
19 See OEE, above n 11.
21 See C Frade, above n 1; J Niemi-Kiesiläinen and AS Henrikson (2005) *Legal Solutions to Debt Problems in Credit Societies: A Report to the Council of Europe*; OEE, above n 11.
overindebtedness. It is possible that a household with a high debt-to-income ratio could be paying its debts punctually due to a high level of income itself. Thirdly, measures based on default (including legal indicators) are also far from perfect. Default is not an inevitable consequence of overindebtedness when individuals can mobilise external help coming from the social network or even illegal earnings. Furthermore, it is not easy to distinguish problematic situations (accidental default) from those of strategic default, in which the individual deliberately chooses not to pay his or her debts. Fourthly, a financial crisis may occur in a household with no credits if the difficulties are related to the payment of basic provision bills.

The issues related to objective measures of overindebtedness have led some researchers to adopt another type of measure linked to the perception of the individuals about their economic situation (subjective indicators). For example, Betti et al., in a comparative effort to examine overindebtedness across the EU, considered a person to be overindebted if ‘he or she considers that he or she has difficulties in repaying debts, whether consumer debt or a mortgage’. Another recent example of a comparative study is provided by the above-cited research by Gumy, who analysed overindebtedness in 15 EU countries using European Community Household Panel data (from the 1995 wave). A household was considered to be overindebted if a ‘Yes’ answer was given to the question ‘Does the household have to repay debts other than mortgage and are these debts a financial burden?’. This question is not, in our opinion, sufficiently clear to signalise overindebtedness because it contains two distinct ideas, and it suggests that the financial burden must be associated with the combination of mortgage with other debts.

Concerning subjective indicators, we should keep in mind that the meaning of those measures is closely related to the cognitive processes people use to evaluate whether and to what extent they are facing trouble with repayments. In this respect, the Theory of Social Comparison offers a fundamental principle in social cognition which states that people evaluate their behaviour, opinions, attitudes and abilities against others’ behaviour, opinions, attitudes and abilities if non-social means of evaluation are unavailable. Normally, people choose individuals who are closer in terms of key social characteristics (for example, gender, age, occupation) as standards of comparison. When requested to evaluate their financial situation, people may not only compare their current with

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25 J Gumy, above n 20.
their past situations but also with the circumstances of their neighbours, colleagues or even an abstract reference group.

The flaws of perceptive measures are closely related both to the arbitrariness of judgment and the recognition of an individual’s inability to translate specific information into non-contextualised terms, often expressed by means of single numbers or categories. If different social standards are mentally evoked, one can expect a great deal of variation in situations judged to be under the same label. For example, two consumers with entirely different financial patterns may evaluate their situations in a similar way (providing the same answer-category), solely because they have relied on different comparison instances. Similarly, two individuals with comparable situations can evaluate them rather differently because different terms of comparison have come into play.

Financial stress refers to quite different situations across the globe, but if we are interested in measuring it, it would be more convenient to focus on its common denominator rather than the different forms it assumes. For example, the level of anxiety, or feeling pressured about managing their finances, would provide a fair clue as to whether people are struggling with money management.

However, the standards of comparison cannot be isolated from the economic and social realities of the countries to which cognitive agents belong. One can expect that, in general terms, the discrepancy in standards of comparison between two individuals picked at random would be greater between individuals living in different countries than between individuals sharing the same country. In this way, the standards of judgment are adjusted to country realities, taking into account the effect that a country’s socio-economic and cultural characteristics play in considering a financial situation as problematic.

The point here is not the desirability of equal criteria to assess all situations, rather that of comparability. In other words, subjective measures enhance the equivalence of what is being measured—a highly relevant topic in methodological considerations of cross-cultural studies. Along these lines, while in studies aimed to assess the extension of overindebtedness in a specific country, the conclusions can be constrained in some way by the employment of perceptive measures, in cross-national studies, in which a comparative logic is sought, these measures may allow more satisfactory results. Bearing all this in mind, we believe that perceptive measures may contribute to shedding some light on the driving forces behind overindebtedness.

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28 The importance of rigorous and objective criteria for considering a household as overindebted should not be disregarded. Indeed, subjective measures supplemented with objective measures are desirable.
IV. THE CONTEXT OF FINANCIAL STRESS AND OVERINDEBTEDNESS

From what has been said, we may assume that overindebtedness is multidetermined and its causes can be better understood if we take into account the social, legal and economic environment with which households interact. The primary objective of this study is therefore to examine to what extent structural country variables such as GDP, ease of borrowing money, unemployment rate and income inequality determine consumers’ financial difficulties.

GDP of countries will determine households’ income and previous studies have pointed in the direction that low income households are more susceptible to financial stress and overindebtedness.29 A small amount of savings and/or a low income will limit the adjustment strategies of those households to deal with unexpected life shocks. As a result, a greater percentage of overindebted households should be found in countries with less developed economies.

In turn, the impact of the ease of borrowing money on financial well-being is twofold. We suspect that borrowing facilities are connected both to economic prosperity and a culture of credit acceptance. Up to a certain level, borrowing may facilitate financial well-being but may easily lead to financial stress and overindebtedness if the debt burden reaches intolerable levels.

There is a great amount of empirical evidence in psychological literature that shows that, in choice situations, people systematically fail to employ the most efficient strategy, suggesting that the maximisation of profits is not a universal criterion for human decisions. Individuals show consistent patterns of probabilistic reasoning and personal preferences for probabilities. Prospect Theory offers a theoretical framework to explain determinants of choice in risky contexts, developing the ideas of the non-linearity of decision weights, framing effects and loss aversion. The theory explains why certain and improbable events are outweighed relative to events of moderate probability (certainty effect). This tendency contributes to the observed pattern of risk aversion in the domain of gains and of risk seeking in the domain of losses (reflection effect).

In an elegant application of cognitive functioning to consumers’ saving and investment, Laibson stated that when consumers face critical choices that imply trade-offs between current and future rewards (inter-temporal decisions), a delayed effect can be expected. Delayed rewards are not as desirable as current rewards and delayed costs are not as undesirable as current costs. A solution that presents current rewards (for example, credit) and delayed costs (for example, interest rates, instalments) will then be highly attractive.

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As noted in several studies, one of the most prevalent life-events to trigger overindebtedness is unemployment. As such, we can expect that the countries with higher unemployment rates are those which possess a greater percentage of overindebted consumers.

Concerning income inequality, it was discussed in the previous section that financial satisfaction derives from the discrepancy between the current economic situation and the situations of other people with whom individuals compare themselves. If wealth is not smoothly distributed in a society but rather is concentrated in the hands of only a few, individuals located on lower levels of the income pyramid will evaluate their economic situation in a less favourable way, providing that they use those salient upper levels as standards of comparison. It might well be the case that, as the range of possible financial situations diversifies, but only a few have access to the upper levels of the pyramid, a sense of dissatisfaction with their financial situation will be instilled in the majority of the population. If cultural shared goals for individual success place a strong emphasis on material well-being, and the social structure fosters a differential access to achieving that goal, less fortunate individuals will look for alternative modes of climbing the socio-economic pyramid. In this scenario, borrowing, when widely accessible, turns out to be a socially acceptable mode of social upgrading. As this requires fairly conscious cognitive strategies involving decisions and planning, it carries a risk of irresponsible or unskilled management. As such, income inequality can also foster financial stress and overindebtedness.

V. EMPIRICAL STUDY

In order to analyse household financial stress across Europe, a truly comparative methodology is sought. Hantrais and Mangen consider that a study can be said to be comparative if particular issues or phenomena are studied in two or more countries:

> with the express intention of comparing their manifestations in different socio-cultural settings, using the same research instruments, either to carry out secondary analysis of data or to conduct new empirical research.

These requirements were attained in our study in the way that it relies on rigorous data drawn from representative samples of 24 European countries. The same question was tested and asked in the national language(s) of every country/region in a face-to-face interview and using comparable survey techniques.

In the last few years, we have entered a new era of comparative research, characterised by the availability of micro-quantitative cross-national datasets.

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32 See, eg, ASB, above n 1; OEE, above n 11.
33 Cetelem Observer (2004) found that 62 per cent of European citizens agree that consumption is a factor of personal achievement.
34 RK Merton, ‘Social Structure and Anomie’ (1938) 3 American Sociological Review 672 at 682.
35 L Hantrais and SP Mangen, above n 27.
A major example is the European Social Survey (ESS), an academic-driven survey motivated by concerns of methodological and substantive rigour that was launched under the auspices of the European Science Foundation. It is designed to chart and explain the interaction between Europe’s changing institutions and the attitudes, beliefs and behaviour patterns of diverse populations. The methodological quality of the survey is ensured by a strong methodological coordination. This was the survey elected for undertaking an empirical study of household financial stress in some European countries.

A. Data

We considered in the empirical study random samples of 24 European countries available in round two (fielded in 2004/05) of the ESS. The total number of households surveyed was 45,229, the distribution of which ranges from a minimum of 579 units in Iceland to 3026 in the Czech Republic, as displayed in Table 12.1.

Table 12.1 Participating countries in ESS (Round 2, 2004/05)

<table>
<thead>
<tr>
<th>Country</th>
<th>N</th>
</tr>
</thead>
<tbody>
<tr>
<td>Austria</td>
<td>2,256</td>
</tr>
<tr>
<td>Belgium</td>
<td>1,778</td>
</tr>
<tr>
<td>Czech Republic</td>
<td>3,026</td>
</tr>
<tr>
<td>Germany</td>
<td>2,870</td>
</tr>
<tr>
<td>Denmark</td>
<td>1,487</td>
</tr>
<tr>
<td>Estonia</td>
<td>1,989</td>
</tr>
<tr>
<td>Spain</td>
<td>1,663</td>
</tr>
<tr>
<td>Finland</td>
<td>2,022</td>
</tr>
<tr>
<td>Greece</td>
<td>2,406</td>
</tr>
<tr>
<td>Hungary</td>
<td>1,498</td>
</tr>
<tr>
<td>Ireland</td>
<td>2,286</td>
</tr>
<tr>
<td>Iceland</td>
<td>579</td>
</tr>
<tr>
<td>Italy</td>
<td>1,529</td>
</tr>
<tr>
<td>Luxembourg</td>
<td>1,635</td>
</tr>
<tr>
<td>Netherlands</td>
<td>1,881</td>
</tr>
<tr>
<td>Norway</td>
<td>1,760</td>
</tr>
<tr>
<td>Poland</td>
<td>1,716</td>
</tr>
<tr>
<td>Portugal</td>
<td>2,052</td>
</tr>
<tr>
<td>Sweden</td>
<td>1,948</td>
</tr>
<tr>
<td>Slovenia</td>
<td>1,442</td>
</tr>
<tr>
<td>Slovakia</td>
<td>1,512</td>
</tr>
<tr>
<td>Switzerland</td>
<td>2,141</td>
</tr>
<tr>
<td>Turkey</td>
<td>1,856</td>
</tr>
<tr>
<td>United Kingdom</td>
<td>1,897</td>
</tr>
<tr>
<td>Total</td>
<td>45,229</td>
</tr>
</tbody>
</table>

B. Variables

The variables employed in this study were collected at micro and macro levels, that is, individual and country levels, though the analysis focuses on the macro level only. For that purpose, individual data were aggregated by using country means on specific target variables (financial stress and ease of borrowing money, as described below).

Financial stress was measured through a perceptive indicator of the feeling about the household income (one person per household surveyed provided an answer). The specific question was: ‘Which of the descriptions comes closest to

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36 Data and survey information can be found at <www.europeansocialsurvey.org>.
how you feel about your household’s income nowadays?’, with the following response alternatives: ‘living comfortably on present income’, ‘coping on present income’, ‘living is difficult on present income’ and ‘living is very difficult on present income’. This measure should be regarded with caution since the phenomenon it relates to does not fully overlap with overindebtedness. We are aware that a range of alternative explanations for reported financial difficulties might be involved, ranging from a structural lack of income to unrealistic economic expectations. This led us to exclude systematically those cases whose reported serious financial difficulties converged with poverty as defined by objective Eurostat criteria. At the very best, the measure employed can be considered an indirect indicator of overindebtedness. For that reason, we will refrain from using the term ‘overindebtedness’ throughout this Part. For the sake of conceptual rigour, the expression ‘financial stress’ will be used instead, although empirical articulations between the two concepts are implicitly assumed.

The other explanatory variable considered is ease of borrowing money to make ends meet. The corresponding question is: ‘If for some reason you were in serious financial difficulties and had to borrow money to make ends meet, how difficult or easy would that be?’. The options provided are: ‘very difficult’, ‘quite difficult’, ‘neither easy nor difficult’, ‘quite easy’ and ‘very easy’.

Additionally, we considered three macroeconomic indicators: gross domestic product, Gini coefficient and unemployment rate, selected from Eurostat. Gross domestic product (GDP) is a measure of the results of economic activity in purchasing power standards (PPS). It is the value of all goods and services produced less the value of any goods or services used in producing them. It permits comparisons between economies of different sizes.37

The Gini coefficient, a measure of income inequality, is one of the 18 Laeken indicators of social exclusion and poverty that the European Council established in 2001. Another Laeken indicator considered was the harmonised unemployment rates (yearly averages). All of these indicators referred to the period between 2000 and 2005, overlapping with the ESS field study.

VI. RESULTS AND DISCUSSION

A. Macro Analysis of Financial and Borrowing Perceptions

We report here a brief statistical description of the variables ‘difficulty of living on present income’ and ‘ease of borrowing money’. The figures displayed in Table 12.2 and Graphs 12.1 and 12.2 are country means and corresponding confidence intervals (95 per cent).

Concerning ‘difficulty of living on present income’, in Austria, for instance, on a scale ranging from one (living comfortably) to four (very difficult), we are

95 per cent confident that the population average lies between 1.70 and 1.79 which means that, generally speaking, Austrians don’t feel they have difficulties living on their present income.

It may be observed that the countries where people, on average, feel more comfortable on their present income are Denmark, Iceland, Sweden, Norway and Ireland. On the contrary, in Slovakia, Greece, Estonia, Turkey, Poland, the Czech Republic, Portugal and Hungary, people reported having more difficulties in living on their present income.

Regarding ‘ease of borrowing money to make ends meet’, in Austria, for instance, on a scale ranging from one (very difficult) to five (very easy), we are 95 per cent confident that the population average lies between 2.90 and 3.00 which means that, overall, Austrians don’t find it easy or difficult to borrow money. When analysing the entire set of countries, the pattern above roughly repeats itself. In Iceland, Denmark, Sweden, Norway and Ireland, people, on average, find borrowing money easier than those in countries such as Estonia, Greece, Turkey, Slovakia, Portugal, Hungary and the Czech Republic. Slovenia is a particular case of a country in which people find it difficult to borrow money even though they feel positive about their present incomes.

Figure 12.1 Mean values and 95 per cent confidence interval of ‘difficult to live on household’s income’* for the 24 countries (ESS, 2004/05)

* Measured by the question: ‘Which of the descriptions comes closest to how you feel about your household’s income nowadays?’, with the following response alternatives: ‘living comfortably on present income’ (1), ‘coping on present income’ (2), ‘living is difficult on present income’ (3), and ‘living is very difficult on present income’ (4).
Table 12.2 Mean values and 95 per cent confidence intervals for the 24 countries (ESS, 2004/05)

<table>
<thead>
<tr>
<th></th>
<th>Difficult of living on household income</th>
<th>Ease of borrowing money to make ends meet</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Mean 95% Lower Bond 95% Upper Bond</td>
<td>Mean 95% Lower Bond 95% Upper Bond</td>
</tr>
<tr>
<td>Austria</td>
<td>1.73 1.70 1.76</td>
<td>2.95 2.90 3.00</td>
</tr>
<tr>
<td>Belgium</td>
<td>1.91 1.87 1.95</td>
<td>2.82 2.76 2.88</td>
</tr>
<tr>
<td>Czech Republic</td>
<td>2.43 2.40 2.46</td>
<td>2.50 2.46 2.54</td>
</tr>
<tr>
<td>Germany</td>
<td>1.92 1.89 1.95</td>
<td>2.80 2.76 2.84</td>
</tr>
<tr>
<td>Denmark</td>
<td>1.43 1.40 1.46</td>
<td>3.96 3.90 4.02</td>
</tr>
<tr>
<td>Estonia</td>
<td>2.52 2.48 2.56</td>
<td>2.11 2.06 2.16</td>
</tr>
<tr>
<td>Spain</td>
<td>1.84 1.80 1.88</td>
<td>2.90 2.84 2.96</td>
</tr>
<tr>
<td>Finland</td>
<td>1.95 1.92 1.98</td>
<td>3.17 3.12 3.22</td>
</tr>
<tr>
<td>Greece</td>
<td>2.54 2.51 2.57</td>
<td>3.33 3.27 3.39</td>
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<tr>
<td>Hungary</td>
<td>2.37 2.33 2.41</td>
<td>2.19 2.14 2.24</td>
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<tr>
<td>Ireland</td>
<td>1.61 1.58 1.64</td>
<td>2.36 2.30 2.42</td>
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<td>Iceland</td>
<td>1.56 1.50 1.62</td>
<td>3.50 3.45 3.55</td>
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<td>Italy</td>
<td>2.02 1.98 2.06</td>
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<td>Luxembourg</td>
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<td>Netherlands</td>
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<td>Norway</td>
<td>1.59 1.56 1.62</td>
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<td>Poland</td>
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<td>Slovakia</td>
<td>2.65 2.61 2.69</td>
<td>2.04 1.98 2.10</td>
</tr>
<tr>
<td>Switzerland</td>
<td>1.67 1.64 1.70</td>
<td>2.61 2.56 2.66</td>
</tr>
<tr>
<td>Turkey</td>
<td>2.47 2.43 2.51</td>
<td>2.31 2.26 2.36</td>
</tr>
<tr>
<td>United Kingdom</td>
<td>1.82 1.78 1.86</td>
<td>2.64 2.59 2.69</td>
</tr>
</tbody>
</table>

The obtained arrangement of countries brings up the hypothesis that GDP might explain the observed variation in the financial and borrowing conditions in those countries. One way of illustrating this point is by plotting the GDP values (2000–2003 averaged) against the variables under study (Graphs 12.3 and 12.4).

Two groups clearly emerge: on the right-hand side, a group formed by countries with a lower GDP and where people find it more difficult to live on their present income and, on the left-hand side, in contrast, a group of countries with a higher GDP and a more positive feeling about personal finances. Indeed, the degree of association between the two variables, computed through Pearson product-moment coefficient, is equal to $r = -0.79$. The coefficient of determination ($r^2$) describes to what extent the variability observed among country means...
Figure 12.2 Mean values and 95 per cent confidence interval of ‘ease of borrowing money to make the ends meet’ for the 24 countries (ESS, 2004/05)

Figure 12.3 Relationship between ‘difficulty of living on household’s income’ and GDP in the 24 countries

b Measured by the question: ‘If for some reason you were in serious financial difficulties and had to borrow money to make ends meet, how difficult or easy would that be?’, with the following response alternatives: ‘very difficult’ (1), ‘quite difficult’ (2), ‘neither easy nor difficult’ (3), ‘quite easy’ (4) and ‘very easy’ (5).
can be explained by GDP. It is expressed in percentages and in this case reaches 63 per cent.

For the sake of visual clarification, three thresholds are depicted in Figure 12.3: one at 1.5, which separates Denmark from the rest as being the only country where, on average, people reported living comfortably on their present income; next, at 2.0, delimits on the left-hand side countries where, on average, people report not having difficulties living on their present income; the one at 2.5 demarcates, on the left-hand side, countries where people on average reported at least slight difficulties in living on their present income. Again, Slovenia appears as an exception whose GDP is comparable to the Czech Republic or Greece while at the same time people report not having difficulties on their present income.

Regarding the ease of borrowing money to make ends meet, we can observe in Figure 12.4 a positive relationship between this variable and GDP. On average, it is easier to borrow money in countries with a higher GDP ($r = 0.65$), as one would expect. The percentage of variability in country means accounted for by GDP is 42.1 per cent. Furthermore, for understanding what type of borrowing was involved in this question, we analyse the correlation between these country means and level of household indebtedness as provided by L’Observatoire de L’Epargne Européenne. The positive association between these indicators and the ease of borrowing money is relatively high ($r = .67$) and remains so ($r_p = 0.66$) even when controlled for GDP (virtually comparing countries with the same GDP). We can therefore assume that the 44.4 per cent of part of variability in country means of ease of borrowing can be explained by variability in households’ indebtedness levels.

B. Macro Analysis of Financial Stress

Some limitations regarding the results mentioned above are apparent. First, we are dealing with country averages of individual answers which can obscure the reality of countries whose variability of individual answers is neglected. Second, the scale of ‘difficulty of living on present income’ does not distinguish on the more negative pole, that is, the category ‘very difficult to live on present income’, those situations that may arise from a lack of income (proxy measure of poverty) from those more related to unsuitability of income (proxy measure of overindebtedness).

For the reasons already discussed in this Chapter, we propose here a more refined measure of household financial stress with some empirical articulation with perceived overindebtedness. Its aim is to identify those individuals who are facing serious difficulties on their present income but are considered as living

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below the national poverty line. Thus, we adopted the Eurostat criterion of relative income poverty which characterises ‘individuals living in households where income is below the threshold of 60 per cent of the national equivalised median income’. This enabled us to identify households whose income was falling into poverty boundaries and in that way we excluded them from the subsequent analysis. We kept only those individuals who answered on the negative pole of the scale of ‘difficulty of living on present income’, that is, those non-poor respondents who reported that it was very difficult to live on their present income, that is, non-poor households who are facing financial stress.

Table 12.3 and Figure 12.5 show the percentage of households experiencing financial stress. For example, in Austria we are 95 per cent confident that the percentage of non-poor people who gave such an answer is between 1.3 per cent and 3.1 per cent. The percentages vary, on average, between 0.9 per cent (Denmark, Finland and Ireland) and 14.1 per cent (Slovakia). The countries where the percentage of non-poor households experiencing financial stress is greater are Slovakia (14.1 per cent), Estonia (10.5 per cent), the Czech Republic (9.7 per cent), Portugal (9.0 per cent), Greece (8.7 per cent) and Turkey (7.9 per cent). On the other hand, the countries with a lower percentage of people who

Figure 12.4 Relationship between ‘ease of borrowing money to make the ends meet’ and GDP in the 24 countries (ESS, 2004/05)
find it very difficult to live on their present income are Ireland (0.9 per cent), Finland (0.9 per cent), Denmark (0.9 per cent), Sweden (1.1 per cent), Slovenia (1.3 per cent) and Norway (1.4 per cent). It is worthy of note that in most of the countries considered, that is 15 out of 24 countries, the percentage of non-poor households living with difficulties does not go beyond 3 per cent, whereas in countries where non-poor people report more difficulties, the percentage of non-poor households experiencing financial difficulties surpasses 7 per cent.

We can thus see a clear demarcation between these two groups: a group of countries with low percentages (up to 3 per cent) of non-poor households living with difficulties and a group of countries with a considerable percentage (over 7 per cent) of non-poor households experiencing difficulties. These two thresholds are depicted in Figure 12.7. The only two countries that fall within these boundaries are Poland (4 per cent) and Hungary (5.1 per cent).

Table 12.3 Percentage of households experiencing financial stress and 95 per cent confidence interval in the 24 countries (ESS, 2004/05)

<table>
<thead>
<tr>
<th>Percentage</th>
<th>95% Lower Bond</th>
<th>95% Upper Bond</th>
</tr>
</thead>
<tbody>
<tr>
<td>Austria</td>
<td>2.2</td>
<td>1.32</td>
</tr>
<tr>
<td>Belgium</td>
<td>2.3</td>
<td>1.44</td>
</tr>
<tr>
<td>Czech Republic</td>
<td>9.7</td>
<td>8.25</td>
</tr>
<tr>
<td>Denmark</td>
<td>0.9</td>
<td>0.35</td>
</tr>
<tr>
<td>Estonia</td>
<td>10.5</td>
<td>8.89</td>
</tr>
<tr>
<td>Finland</td>
<td>0.9</td>
<td>0.41</td>
</tr>
<tr>
<td>Germany</td>
<td>2.0</td>
<td>1.35</td>
</tr>
<tr>
<td>Greece</td>
<td>8.7</td>
<td>7.13</td>
</tr>
<tr>
<td>Hungary</td>
<td>5.1</td>
<td>3.65</td>
</tr>
<tr>
<td>Iceland</td>
<td>2.8</td>
<td>1.23</td>
</tr>
<tr>
<td>Ireland</td>
<td>0.9</td>
<td>0.41</td>
</tr>
<tr>
<td>Italy</td>
<td>2.3</td>
<td>1.34</td>
</tr>
<tr>
<td>Luxembourg</td>
<td>2.3</td>
<td>1.34</td>
</tr>
<tr>
<td>Netherlands</td>
<td>2.1</td>
<td>1.36</td>
</tr>
<tr>
<td>Norway</td>
<td>1.4</td>
<td>0.81</td>
</tr>
<tr>
<td>Poland</td>
<td>4.0</td>
<td>2.94</td>
</tr>
<tr>
<td>Portugal</td>
<td>9.0</td>
<td>7.22</td>
</tr>
<tr>
<td>Slovakia</td>
<td>14.1</td>
<td>0.00</td>
</tr>
<tr>
<td>Slovenia</td>
<td>1.3</td>
<td>0.54</td>
</tr>
<tr>
<td>Spain</td>
<td>1.8</td>
<td>0.96</td>
</tr>
<tr>
<td>Sweden</td>
<td>1.1</td>
<td>0.59</td>
</tr>
<tr>
<td>Switzerland</td>
<td>1.4</td>
<td>0.79</td>
</tr>
<tr>
<td>Turkey</td>
<td>7.9</td>
<td>6.41</td>
</tr>
<tr>
<td>United Kingdom</td>
<td>2.2</td>
<td>1.38</td>
</tr>
</tbody>
</table>
Following the same logic as before, we plotted (Figure 12.6) the percentage of non-poor households experiencing financial stress against GDP and we found that the previously discussed association between financial conditions and GDP remains for this case. GDP explains 52.7 per cent of the variability observed in percentages among countries ($r = -0.73$). Countries with higher percentages of non-poor households struggling on their present income have lower GDP while the opposite holds for countries with lower percentages. However, this relationship does not progress smoothly along the two axes. Indeed, there is a marked distinction between countries with a GDP below or above 75 per cent of EU purchasing power standards. An invisible line at this point would give us the two groups identified in Figure 12.3. We can see once more that the critical countries with a greater percentage of households experiencing financial stress (Slovakia, Estonia, the Czech Republic, Turkey, Portugal, Greece, Hungary and Poland) are those whose GDP falls up to around 75 per cent. Slovenia appears here as contrary to this tendency, where the GDP is about 75 per cent but it presents a low percentage of households facing financial stress.

In the second place, we analysed financial stress, taking into account the ease of borrowing money in those countries. We can see that countries with greater percentages of non-poor households living in difficulties are those in which borrowing money becomes more difficult ($r = -0.64$). When controlled for GDP,
this coefficient rises to $r_p = -0.78$. It indicates a negative relationship in the sense that countries where borrowing money is easier have a lower percentage of non-poor households experiencing financial stress. The coefficient of determination ($r^2$) reaches 60 per cent in this case. Slovenia and Hungary appear as two exceptions to the tendency discussed. They present lower to moderate percentages of non-poor people with financial stress, yet there is some degree of difficulty in borrowing money. In the Slovenian case, the obstacles against borrowing money are extremely high compared with other countries, but this does not reflect on financial stress (Figure 12.7).

These results should be regarded with caution since ease of borrowing only would lead to overindebtedness if in fact people took advantage of it to the extent of overborrowing. Important social and cultural factors come into play in this relationship and therefore should not be overlooked. The misinterpretation of these values as suggesting that as accessibility of borrowing increases, financial stress will decrease should be avoided at this point.

As far as unemployment rate is concerned, the picture that emerges is not as clear as in the previous analysis. There is no sharp distinction in unemployment rates between countries with low or high percentages of non-poor households struggling to manage their finances. We can observe two extreme positive cases
regarding unemployment rate (Poland and Slovakia) but with radically different figures for financial stress (cf Figure 12.8). However, statistically speaking, there seems to be a positive association indicating that the higher the unemployment rate, the higher the percentage of non-poor households experiencing financial stress, as shown by the Pearson correlation of $r = 0.54$. However, this value is illusory since the correlation falls to approximately zero when partialised to GDP.

Surprisingly, the results suggest that the unemployment rate doesn’t seem to be associated with financial stress among the non-poor. There are a number of explanations for this result: for example, job loss does not necessarily imply a loss of income as an unemployment subsidy may temporarily substitute income and help the household to keep financial equilibrium, especially when the period that mediates between the loss of job and the first instalment of the unemployment subsidy is not too long.

A recent study carried out by the Observatory of Consumers’ Indebtedness,40 the aim of which was to analyse the linkages between unemployment and overindebtedness, provides evidence that even though unemployment appears

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40 C Frade and C Lopes, above n 6.
to be a major cause of overindebtedness among Portuguese consumers, unemployment per se does not lead to overindebtedness. The most important results of the study were illustrated in a triangle (of overindebtedness) in which three causes (vertices) must be present for overindebtedness to occur. In this framework, a serious decline in labour conditions, multi-indebtedness and no savings and/or weak social networks are necessary (but not sufficient) conditions conducive to overindebtedness. We should therefore take into account these and other potential factors and their manifestations in each country in order to state a firmer conclusion about the effect of unemployment on financial stress.

A very last hypothesis is that inequality in income distribution (measured by the Gini coefficient) could also explain part of the variability between countries on the perceived overindebtedness. The correlation coefficient obtained between the two variables is fairly high, showing a strong positive association between both variables ($r = 0.72$). This means that we expect great percentages of non-poor households living with much difficulty in countries with a great deal of income inequality.

We can also hypothesise that GDP and the Gini coefficient are to some extent associated, so that part of the association between perceived overindebtedness and income inequality can also be accounted for by GDP. In order to eliminate
the effect of GDP in this association, we computed a partial correlation coefficient and observed that the association between perceived overindebtedness and income inequality still remains. Indeed, when statistically controlled for GDP (that is, virtually comparing countries with the same GDP), income inequality explains 33.4 per cent of the variability in financial stress ($r_p = 0.58$).

Figure 12.9 suggests the trend that countries with a greater Gini coefficient are more likely to have a greater percentage of non-poor households living with difficulties. This relationship is evident in countries like Portugal, Estonia and Greece (on the right-hand side), and Denmark, Slovenia and Norway (on the left-hand side). However, the same cannot be applied, for example, to Spain and the UK, which possess high income inequality and a lower percentage of households struggling on their present income, and the Czech Republic, which has lower income inequality and a high percentage of non-poor people living with difficulties.

Table 12.4 sums up the main results presented so far. Correlation coefficients for the association between percentage of non-poor households experiencing financial stress and each one of the economic indicators considered are dis-

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**Figure 12.9 Relationship between percentages of households experiencing financial stress and income inequality (Gini coefficient in 2001)**

![Figure 12.9 Relationship between percentages of households experiencing financial stress and income inequality (Gini coefficient in 2001)](image-url)
played. Note that since all of the structural indicators correlate largely with GDP, the correlation coefficients were controlled for it: that is, the explanatory power of GDP to obscure the relationships was removed. Apart from GDP, none of these coefficients are associated with one another.

It can be observed that a high GDP, facilities for borrowing money and a low income inequality are structural factors that seem to be associated with lower percentages of non-poor households facing financial stress in the countries considered. Income inequality appears to be the structural condition with the greatest impact on financial stress.

It is important to keep in mind that none of these factors per se leads to household financial stress. For example, Spain and the UK are countries with a considerably high income inequality but the percentage of non-poor households experiencing financial stress is considerably low. Poland, for example, is a country with a low GDP, but this does not inevitably lead to a high percentage of household financial stress. Another example is Slovenia, which emerges as an outlier in some of the analyses performed, showing that it possesses a not very high GDP and a very low ease of borrowing money, yet presents a lower percentage of non-poor people living with financial stress. Two other countries with a similar pattern to Slovenia but different outcomes are the Czech Republic and Hungary, where the GDP is somewhat lower, but not very much so, and there are, on average, difficulties in borrowing money, but this translates into greater percentages of non-poor people struggling to manage their finances, especially in the Czech Republic.

Unambiguous conclusions can be drawn for more obvious situations. In all countries with consistently low GDPs, perception of existing difficulties in borrowing money and income inequality (for example, Estonia, Greece and Portugal), a high percentage of non-poor households experiencing financial stress was observed. Conversely, countries with a high GDP, ease of borrowing money and low income inequality (for example, Denmark, Germany and Ireland) show lower percentages of non-poor households living with difficulties.

Table 12.4 Pearson’s correlation coefficients for the association between percentages of households experiencing financial stress and macro-economic variables (N=24)

<table>
<thead>
<tr>
<th></th>
<th>Percentage of households experiencing financial stress</th>
</tr>
</thead>
<tbody>
<tr>
<td>GDP</td>
<td>-0.65</td>
</tr>
<tr>
<td>Ease of borrowing money</td>
<td>-0.78</td>
</tr>
<tr>
<td>Income inequality</td>
<td>0.82</td>
</tr>
<tr>
<td>Unemployment rate</td>
<td>approx. 0</td>
</tr>
</tbody>
</table>
VII. CONCLUSION

This study provides evidence that financial stress among the non-poor is associated with structural characteristics, such as GDP, borrowing conditions and income inequality, in the 24 European countries analysed. The main conclusions are that countries that possess a higher percentage of households experiencing financial stress have a lower GDP, more restrictions on borrowing money and greater income inequality. However, there are substantial variations among countries in the mentioned structural patterns, suggesting that non-considered cultural variables, such as social attitudes and values, come into play to explain the differential impact of the macroeconomic context on financial stress. As noted, cultural and structural factors are intertwined, making it difficult to estimate their separate impacts on household finances, but their inclusion in further comparative studies of financial stress and overindebtedness may bring important insights to the field and improve the heuristic value of quantitative studies.

A more fine-tuned analysis of financial stress should go further by interpreting not only the general trend but also the deviant cases. The exceptional countries that fall far off the general trend suggest new corrective insights. In this scenario, Slovenia comes up as a country that, despite the adverse circumstances, does not succumb easily to household financial stress. Further exploration of this particular case may reveal what sort of aspects attenuate the impact of those macroeconomic factors on financial stress.

Finally, we are aware of the methodological limitations of this study, namely its cross-sectional nature, the non-consideration of socio-cultural variables and the limitations of using an indicator of financial stress as a proxy of subjective overindebtedness. Further refinement of this measure is a priority in our future research agenda. The examination of risks of financial stress simultaneously across households and countries is also a path open to exploration. Empirical studies using alternative methodologies, such as longitudinal or multi-level, are sought in order to give a more consistent picture of the structural and cultural forces shaping overindebtedness. A more comprehensive knowledge of this social and economic problem will enable a more proficient regulation.
Bankruptcy in Germany: Filing Rates and the People behind the Numbers

WOLFRAM BACKERT, DITMAR BROCK, GÖTZ LECHNER AND KATJA MAISCHATZ

I. INTRODUCTION

THE GERMANS HAVE always been reputed for their accuracy and reliability. However, over the last decades the Germans have been leaving quite a disorderly impression when it comes to repaying debts. Like in other countries, the number of households in debt and in overindebtedness has increased: between 1999 and 2002, the estimated number of households unable to pay their debts grew from 2.77 million to 3.1 million households.\(^1\) According to the National Bureau of Census, in 2004 about 8 per cent of German households were overindebted.\(^2\) The findings of the ‘Schufa Schuldent-Kompass’\(^3\) show a geographical component in the distribution of debt problems in Germany: The wealthy south of Germany is not so much affected as the northern parts, which are struggling with economic problems. The inhabitants of the German capital Berlin are facing the most serious debt problems among the German cities.

The increasing number of overindebted persons finally led to an important amendment to the German insolvency statute, which became operative in the year 1999. After 30 years of debate, German law finally provided a procedure for the discharge of indebtedness, the so-called InsO. Before 1999, the only possibility for individual German debtors was to look for an advisory service for debtors or to get used to a life with asset seizures. After an amendment

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\(^2\) Statistisches Bundesamt Datenreport 2004 (Bonn 2004) at 600 ff.

concerning the cost of the lawsuit in the year 2001, more and more debtors have filed for bankruptcy to regain economic and social inclusion.

This Chapter deals with the filing rates in Germany and the people behind these rates. For the first time in Germany, people who filed for bankruptcy have been questioned about their lives, the reasons for bankruptcy and the consequences of living with financial failure. After a short introduction to the procedures of the German insolvency statute and their consequences for filing rates, we will provide a short description of our research project, which was granted by the German Research Foundation (DFG). Thereafter we present some of our results, showing some basic sociodemographic data and social structural findings about the people in our sample, and the reasons discovered for debt and insolvency. We conclude with some discussion about the procedures required by the statute and their effects on who files for bankruptcy in Germany.

II. THE GERMAN INSOLVENCY LAW: THE LONG WAY BACK TO A DEBT-FREE LIFE

With the amendment of the new German Insolvency Statute in 1999, the legislator created a legal institution that makes it possible for insolvent private households in Germany\(^4\) to file for bankruptcy. Up to that time, the possibility of discharge had been reserved to enterprises. A further change in the Insolvency Statute in December 2001 provided for the deferral of court costs in all the cases of private bankruptcies in which the debtor cannot afford to pay the costs of the lawsuit from his/her own financial resources. At least theoretically, this latter change has opened the doors of insolvency procedure to all private debtors.

The number of opened insolvency procedures shows the effect of the 2001 statutory change allowing the deferral of court costs. From 1999 to 2001 the number of opened procedures quintupled from 1,634 to 9,070. An exponential growth in the number of procedures followed the amendment. From 1,634 persons filing for bankruptcy in 1999 the number grew to 92,844 in 2006 according to the National Bureau of Census (2002: 19,857 opened procedures; 2005: 66,945 opened procedures). At the same time, the average debt sum per case has been decreasing continuously (1999: €179,000, 2005: €69,000), suggesting a greater accessibility of the insolvency procedures to less wealthy persons.\(^5\)

Private bankruptcy in Germany can be procedurally divided into four stages, which the honest debtor has to go through one after another if he wants to be debt-free after approximately six years.

Phase 1 describes the so-called attempt to reach an out-of-court agreement during which the debtor tries to reach an arrangement with his creditors about a debt clearing plan. In this phase of the process debt counselling agencies or lawyers are involved, which have to certify that the attempt was made and did

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\(^4\) There were over 3 million such households in Germany in 2002. D. Korzack 2004, above n 1, at 46

not show the intended result of an out-of-court agreement. There is often a queue to get an appointment with the debt counselling agencies—so impetuous debtors especially, who cannot afford a lawyer, have to wait until they gain access to the bankruptcy proceedings.

If this attempt fails, that is, if there is no agreement with the creditors, the debtor enters into phase 2: after a formal filing for an application by the debtor and an examination by the relevant insolvency court, the opening of the judicial debt-clearing procedure is constituted. In this procedural stage, again, the parties try to achieve a debt-clearing plan.

If this attempt to reach an agreement fails, phase 3, the simplified insolvency procedure, follows. Now, a custodian appointed by the court distributes the debtor’s personal estate to all creditors on a pro rata basis. However, exemptions in this process allow the debtor to keep things for personal and daily use. Things for daily use, TV sets, computers and cars of low value (when needed for work proposes) are usually exempt to guarantee the socio-economic existence minimum and to keep up the possibility for the debtor to enter the workforce.6

In the last phase, phase 4, the procedure of discharge from remaining debts, the so-called period of good conduct (Wohlverhaltensperiode) begins, which lasts six years.7 Among other things the debtor is obliged to pursue gainful employment—either to perform a reasonable job (angemessene Arbeit) or, in case of unemployment, to try really hard to get a job. Part of the debtors’ income above an exempt amount must be paid to the custodian. In addition inheritances must be transferred to the custodian. With the end of the period of good conduct (Wohlverhaltensperiode), the discharge of remaining debts is announced by the court and with it, the debtor is released from all his debts.

III. DESCRIPTION OF THE RESEARCH PROJECTS

Until this study, there has been no reliable information about the characteristics of the individuals initiating the ever-increasing number of insolvency proceedings. Previous reports are either not representative or merely based on client statistics of debt counselling agencies. For more than 10 years this research team, headed by the Chair of Sociology II at Chemnitz University of Technology, has been dealing with questions referring to the phenomenon of private bankruptcy. Our research has been funded by the German Research Foundation. In addition to providing information about who initiates insolvency proceedings, we will

6 Zivilprozessordnung (Code of Civil Procedure, hereinafter ZPO) s 811; Insolvenzordnung (Insolvency Act, hereinafter InsO) s 36. For a relatively recent English translation of the Insolvency Act online, see <http://www.iuscomp.org/gla/statutes/InsO.pdf>. For an updated German language version of the InsO, see <http://www.inso-rechtspfleger.de/inhalt/04_materialien/inso_text/indexa.html>. In most of the cases there is not much of value left. Things for personal use, such as television sets, furniture or used and older cars are usually not of enough value to justify a foreclosure sale. In some parts of East Germany houses and other real estate properties did not find interested buyers.
7 InsO, s 295 ff.
report on the different causes of consumer overindebtedness leading to insolvency proceedings, and the different conditions for access to the procedure.

Information of these reports came from two different sources. First we interviewed, in person, a large number of professional participants in the procedure: insolvency judges, judicial officers (Rechtspfleger), attorneys at insolvency law and debt counsellors. We asked about both their operating and their context knowledge about procedures and debtors. Second, we interviewed the debtors themselves via a postal survey. In January 2007, about 18,300 questionnaires were sent to persons who had opened a legal procedure during 2005 and 2006. About two weeks later a reminder letter was sent. The survey was conducted in the old West German states of Lower Saxony and Hesse, and in the following newly formed German states: Saxony, Brandenburg, Thuringia, Saxony-Anhalt and Mecklenburg-Western Pomerania. In total 1,622 people participated in our study. The response rate amounts to roughly 9 per cent, about 8 per cent in West Germany and 11 per cent in East Germany. In Lower Saxony 766 people responded, 328 from Hesse, and altogether 528 questionnaires from the former GDR were sent back to us.

The first issue is whether the responses to the postal survey can be considered representative of the population as a whole, given the low response rate. To validate the data as representative, we have turned to two external data sources available: the German Federal Bureau of Census and data from the Schufa, the biggest German credit information company.

The federal census allows us to compare the amount of debt owed by the people in our sample with the amounts that are shown in the official bankruptcy statistics.

Looking at Table 13.1, it is conspicuous that in our sample debtors from West Germany with debt of more than €1 million are overrepresented, at 3 per cent. Additionally, people that owe less than €50,000 are between 4 and 8 per cent underrepresented. Especially the sample in Hesse shows a visible variance. But the fewest responses in the sample come from Hesse, and so they carry less weight in the reports of total responses and bias these results less. The representativeness of the sample from the newly formed states is quite good.

The Schufa database reports on the age and sex of the debtors who filed for bankruptcy in the given regions. Table 13.2 compares that data with the age and sex of respondents to our postal survey.

At first sight women seem to be overrepresented in our sample and men underrepresented (which could be true for Hesse), but we have to consider the composition of the Schufa database. The Schufa database includes data concerning all private bankruptcies, whether filed by individual consumers or bankrupt

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8 Interviews were conducted with two judges, two judicial officers (Rechtspfleger), five debt counsellors, and two attorneys. Interviews were conducted in larger and smaller cities, and in one case in a rural environment, in order to explore if location accounted for differences in counselling and the decision process whether to file for bankruptcy. The differentiation between ‘town’ and ‘country’ will be a topic of further analysis.
entrepreneurs (but corporate business bankruptcies are excluded). About 25 per cent of the insolvencies included in the Schufa database are entrepreneur bankruptcies. Moreover, in Germany around 70 per cent of the holders of business ventures are male.\(^9\) Therefore the Schufa data probably contains a higher proportion of males than it would if it reported only on consumer bankruptcies. It follows that our sample seems to contain an appropriate proportion of the sexes.

Table 13.1 Amount of debt\(^9\)

<table>
<thead>
<tr>
<th>Amount of debt in € (in per cent)</th>
<th>Lower Saxony sample (in per cent)</th>
<th>Lower Saxony (in per cent)</th>
<th>Hesse sample (in per cent)</th>
<th>Hesse (in per cent)</th>
<th>Newly formed German States sample (in per cent)</th>
<th>Newly formed German States (in per cent)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Up to 5,000</td>
<td>3.9</td>
<td>4.5</td>
<td>0.9</td>
<td>2.0</td>
<td>5.2</td>
<td>6.1</td>
</tr>
<tr>
<td>5,000–50,000</td>
<td>63.2</td>
<td>67.8</td>
<td>54.6</td>
<td>61.1</td>
<td>68.2</td>
<td>71.1</td>
</tr>
<tr>
<td>50,000–250,000</td>
<td>26.7</td>
<td>24</td>
<td>33.8</td>
<td>29.5</td>
<td>21.2</td>
<td>18.9</td>
</tr>
<tr>
<td>250,000–500,000</td>
<td>3.6</td>
<td>2.6</td>
<td>3.1</td>
<td>4.5</td>
<td>3.3</td>
<td>2.3</td>
</tr>
<tr>
<td>500,000–1 million</td>
<td>0.7</td>
<td>0.9</td>
<td>5.2</td>
<td>1.8</td>
<td>1.1</td>
<td>0.9</td>
</tr>
<tr>
<td>More than 1 million</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Total 100.1  99.8  100  100  99.9

Source: National Bureau of Census, own results.

Table 13.2 Division of sexes in comparison

<table>
<thead>
<tr>
<th>Sex in per cent</th>
<th>Lower Saxony sample</th>
<th>Lower Saxony</th>
<th>Hesse sample</th>
<th>Hesse</th>
<th>Newly formed German States sample</th>
<th>Newly formed German States</th>
</tr>
</thead>
<tbody>
<tr>
<td>Male</td>
<td>53.3</td>
<td>57.4</td>
<td>50.3</td>
<td>58.9</td>
<td>55.1</td>
<td>58.9</td>
</tr>
<tr>
<td>Female</td>
<td>46.7</td>
<td>40.8</td>
<td>49.7</td>
<td>38.4</td>
<td>44.9</td>
<td>39.8</td>
</tr>
</tbody>
</table>

Total 100  98.2  100  97.3  100  98.7

Source: Schufa, own results.


\(^{10}\) Data provided directly to us by the National Bureau of Census.
The Schufa database also contains information about the age of people filing for bankruptcy. Table 13.3 compares this information with comparable information about our sample respondents.

Again, Table 13.3 shows some differences between our sample and the reference data. The average age of our respondents is three years (in Hesse even five years) above the Schufa database average, and the age structure in percentiles turned up as well. But the differences are not dramatic and easy to explain. As we explained with respect to Table 13.2, there are business failures included in the Schufa data. Entrepreneurs are likely to go bankrupt in their ‘earlier’ years, while private bankruptcy is to be found even in the older age groups.

There is—according to the comparisons above—not much evidence to assume a systematic bias in our data. There are no other reliable databases about people in bankruptcy in Germany available to compare with our data. A study of clients of debt counselling agencies carried out by the German National Bureau of Census in 2007 shows, for example, results concerning income, age, and numbers of single-parent households which are very similar to the results in our research project.¹¹ Clients in debt counselling are of course not the same subpopulation as people that actually did file for bankruptcy, but there is a lot of similarity between the two groups. Big differences between the two studies would have made us more sceptical about the quality of our results, but both studies indicate related findings in the sociodemographic composition of the groups, as well as the causes and amounts of debt. From our point of view, and concerning the small available amount of data to compare with, the findings in our project seem to be reliable.

Table 13.3 Age structure in comparison

<table>
<thead>
<tr>
<th>Age Lower Saxony sample</th>
<th>Lower Saxony sample</th>
<th>Hesse formed</th>
<th>Hesse formed</th>
<th>Newly formed German states sample</th>
<th>Newly formed German states sample</th>
</tr>
</thead>
<tbody>
<tr>
<td>Mean 44.6</td>
<td>41.7</td>
<td>47.6</td>
<td>42.5</td>
<td>44.4</td>
<td>41.8</td>
</tr>
<tr>
<td>Percentiles:</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>20</td>
<td>35</td>
<td>32</td>
<td>38</td>
<td>34</td>
<td>33</td>
</tr>
<tr>
<td>40</td>
<td>41</td>
<td>38</td>
<td>44</td>
<td>39</td>
<td>41</td>
</tr>
<tr>
<td>60</td>
<td>47</td>
<td>44</td>
<td>51</td>
<td>44</td>
<td>48</td>
</tr>
<tr>
<td>80</td>
<td>54</td>
<td>51</td>
<td>57</td>
<td>51</td>
<td>54</td>
</tr>
<tr>
<td>n</td>
<td>750</td>
<td>323</td>
<td>517</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Source: Schufa, own results.

IV. WHO FILED FOR BANKRUPTCY? THE PEOPLE IN THE SAMPLE

During recent years there has been an increasing interest in the topics of ‘debt’ and ‘bankruptcy’ in Germany. As a consequence the number of research projects and publications has started to grow. The first reports were about the number and sociodemographics of overindebted people. Overindebtedness has become an important topic in the National Report on Poverty and Wealth. Qualitative projects have provided the first insights about those living with debt and bankruptcy. With the implementation of the InsO not only the persons in debt but also the persons who have managed to get out of their financial problems in the new licit way are of some interest. Our sample provides some concrete insights, for the first time.

Tables 13.2 and 13.3 provide information about the sex and age distribution of respondents to our survey. The difference in the sexes (53.4 per cent were male, 46.3 per cent were female) is not statistically significant. The median age for the entire sample is 45 years. The youngest person in our sample was 22 years old, the oldest at the age of 84. The relatively high median age shows that the development of overindebtedness is a process that normally takes a period of time. And it takes additional time to get out of debt in formal insolvency proceedings. Hence, persons of younger age are under-represented in our sample. But as the example of the 22-year-old debtor indicates: youth is definitely no protection!

Our findings indicate that family status is an important factor in causing bankruptcy. Divorced people form the largest group (36 per cent) in our sample. Another 6 per cent are living separately from their spouse. Married couples form 31 per cent of our sample, single people (never married) form 23 per cent, and 4 per cent are widowed.

In 60 per cent of the households in the sample there are no children. If there are children living in the household, there are mostly one or two children. Among all households in our sample there are only 6.7 per cent of households with three or more children. Single parents, with roughly 16.5 per cent in the


13 See eg, D Korczak, above n 1; G Zimmerman, above n 12.

14 See eg, W Backert and G Lechner, . . . und befreie uns von unseren Gläubigern (Baden-Baden, 2000); W Backert, Leben im modernen Schuldturm (Frankfurt am Main, 2003); A Hirseland, Schulden in der Konsumgesellschaft (Amsterdam, 1999); G Reiter, Kritische Lebensereignisse und Verschuldungskarrieren von Verbrauchern (Berlin, 1991).
sample, are overrepresented in proportion to the German population (7.6 per cent single parents in East and 6.3 per cent in West Germany). The high percentage of divorced persons in the sample is notable but consistent with findings in other countries. Divorce is considered one of the ‘Big Three’ reasons for bankruptcy in the United States.\textsuperscript{15}

The undisputed first rank within the ‘Big Three’ reasons in the United States is unemployment, and that is also true in Germany. In our sample 42.8 per cent of our queried persons said that unemployment was the primary reason for their financial failure.\textsuperscript{16} Unemployment is normally associated with low income, and that is the case for our sample. During their bankruptcy proceedings, 42.4 per cent of the persons in our sample received the so-called ALG II. The ALG II is a mixture between social welfare and a special kind of unemployment benefit for long-term unemployed persons who are on the dole for more than one year. The monetary level is oriented towards the amount of money needed to live at a subsistence level. Another 5.9 per cent of our sample receive an unemployment benefit, suggesting that their unemployment has not been of such long duration, and 4.4 per cent receive social welfare. Altogether 52.7 per cent of the people in our sample receive direct supports from the social security system or public unemployment insurance. Not all of these people are fully dependent on the social security system, however. Forty-nine percent of them live primarily on wages and another 5.4 per cent are self-employed in business or professional activities.

Table 13.4 shows the monthly income sources of the households in our sample (multiple mentions possible):

<table>
<thead>
<tr>
<th>Source of Income</th>
<th>Relative Frequency</th>
</tr>
</thead>
<tbody>
<tr>
<td>Wages</td>
<td>49.0%</td>
</tr>
<tr>
<td>ALG II Social Welfare—Unemployment Benefit</td>
<td>42.4%</td>
</tr>
<tr>
<td>Children’s Allowance</td>
<td>39.3%</td>
</tr>
<tr>
<td>Pension</td>
<td>9.7%</td>
</tr>
<tr>
<td>Permanent Invalidity Pension</td>
<td>6.6%</td>
</tr>
<tr>
<td>Housing Subsidy</td>
<td>6.4%</td>
</tr>
<tr>
<td>Other</td>
<td>7.0%</td>
</tr>
<tr>
<td>Alimony</td>
<td>9.7%</td>
</tr>
<tr>
<td>Self Employed</td>
<td>5.4%</td>
</tr>
<tr>
<td>Unemployment Benefit</td>
<td>5.9%</td>
</tr>
<tr>
<td>Permanent Invalidity Pension</td>
<td>6.6%</td>
</tr>
</tbody>
</table>


The median income in our sample totals around €1,200, the arithmetic mean is about €1,125—the range is between €400 and more than €6,000 per month.\(^{17}\) On average, our findings show that people in bankruptcy have relatively low income and problems with the labour market.

Where do these problems come from? It is often said that there is an interrelation between lower education and unemployment.\(^{18}\) Yet our data points to only minor deviations in the educational level between the German population and the people in our sample. The German educational system is relatively strictly divided into three parts: lower education, called *Haushaltsabschluss* (Lower Education II) or *Volksschule* (Lower Education I); middle education, the *Mittlere Reife*, or in former East Germany the so-called POS degree; and the higher degree of education, which gives students admission to universities of applied sciences (Higher Education II) or regular university (Higher Education I). In recent years, there has been an enormous trend towards higher education and at the same time a decrease of low-grade school qualifications and a decline of chances on the labour market for people with poor education.\(^{19}\)

In our sample more than 20 per cent of the respondents have higher education, a proportion near to the normal German population. By comparison, the ALLBUS, a representative inquiry of the German population, quotes that 23 per cent of people have higher education.\(^{20}\) Nearly 40 per cent of our respondents have no or only lower certifications, compared with a 42 per cent finding by ALLBUS for the national population. The remaining 40 per cent of our respondents have the middle level of educational achievement, compared with 34 per cent of the national population.\(^{21}\) Lack of education, therefore, does not appear to create aggravated risks for running into debt problems, nor does higher education appear to minimise the danger of getting into financial embarrassment. There may be trouble with integration into the labour market, because the people in our sample seem to have problems in transferring their skills and education into prospects on the labour market as shown above, but relevant differences in the educational level do not show up in our data.

A similar picture appears during the analysis of social inequality and the measurement of the socio-economic position of the people in our sample in comparison with the German population. Table 13.5 shows the ISEI Ganzeboom

\(^{17}\) The study about the clients of debt counselling agencies, realised by the German National Bureau of Census, shows an average household income of €1,144 per month. J Angele, above n 11, at 948.


\(^{19}\) R Geißler, above n 18, at 344, 333 ff.

\(^{20}\) The ALLBUS database is not publicly available free of charge. For similar public statistics, see Statistisches Bundesamt, *Bildung im Zahlenspiegel 2006* (Bonn, 2007) at 30 and Table 2.4.1.

\(^{21}\) The overrepresentation of the middle levels of education may be due to the proportional higher degree of East German respondents in our sample—the POS with ten years of school was the most common degree of education in the former GDR.
Index of Occupational Status. The curve on the left side shows the position of the people who filed for bankruptcy, the right curve the distribution in the ALLBUS inquiry.

From the lowest to the highest status position, bankruptcy occurs over the full range of positions in Germany. Filing for bankruptcy is not an experience limited to people at the lower end of society. Nonetheless, there are some more people in lower prestige positions, like unskilled workers, and fewer people at the upper end of the distribution, as Table 13.5 indicates.

Table 13.5 Socio-economic position, percentages cumulated


To give an idea of the status positions in the following some examples: in the lowest position, 16, we find unskilled farm labourers and domestic workers, 28 stands for semi-skilled workers, 64 for creative professions, eg, choreographers, 74 stands for academic professions like geologists, and the highest position 88 stands for physicians.
V. REASONS FOR BANKRUPTCY, AND WHO ARE THE CREDITORS?

In the United States unemployment, medical costs, and divorce are the ‘Big Three’ reasons for overindebtedness and private bankruptcy. In Germany—with a more or less functioning system of health insurance—medical costs are not of equal importance and the ‘Big Three’ have a slightly changed composition: ‘Unemployment’, ‘Loss of financial overview’ and ‘Divorce’ are the first three reasons in our findings. As Table 13.6 shows, 42.8 per cent of our interviewees claim unemployment as a reason for their private bankruptcy.

Fourth place goes to ‘Business failure’, followed closely by ‘Too much consumption’, ‘Lack of experience with banks’ and ‘Family problems’. ‘Psychological problems’ and ‘Own sickness’ are ranked at 12th and 15th place. If they were added together, they would rank in fourth place. Consequently, health problems might play a certain and unrecognised role in causing German bankruptcies.

It is very interesting to us that three of the 15 reasons in the table relate to respondent’s own lack of understanding or responsibility. These include ‘Too much consumption’, ‘Lack of experience with banks’ and ‘Lack of experience with money’. Perhaps even ‘Loss of financial overview’, the second most cited reason, sometimes relates to knowledge and personal responsibility. Contrasted with the classical structural and biographical reasons for bankruptcy like ‘Unemployment’, ‘Low income’, or ‘Divorce’, the answers of our respondents

Table 13.6 Reasons for overindebtedness (multiple responses permitted)

![Table 13.6 Reasons for overindebtedness (multiple responses permitted)](image)


24 For the source of the data in this table, see G Lechner and W Backert, ‘Leben im roten Bereich: Daten zum Leben in der Verbraucherinsolvenz’ in Schufa Holding AG, Schulden-Kompass 2007 (Wiesbaden, 2007) at 124.
show that budgeting, knowledge and information seem to play an important part in the development of a debt career. Information and education could be helpful in managing the increasing debt and bankruptcy rates.

To whom is the money owed and for what purpose? In most of the cases in our sample, the debtors have more than one creditor; the median is six creditors per debtor. The range reaches from one creditor in 7.3 per cent of cases up to 99 in only one case. There were more than 10 creditors in more than 26 per cent of the cases.

Table 13.7 shows the types of debts reported by our respondents. Banks are the main creditors. The most common debt, owed by 53.5 per cent of our respondents, is an overdrawn bank account.25 Debts owed to banks are also reflected in the following responses reported in Table 13.7: car loans (21.9 per cent), bank loans (21.6 per cent), real estate mortgages (21.2 per cent), consumer credits (20.9 per cent), and credit cards (12.4 per cent) (multiple answers were possible).

Mail order companies are the second most common creditor of our respondents; 32.6 per cent of our respondents owe money to them.26 Problems with telephone bills are reported by 25 per cent, followed very closely by rent debts (24.7 per cent). Modern communications also exact a high toll: 22.5 per cent of our respondents claim debts in connection with their cellphone—which is rank

<table>
<thead>
<tr>
<th>Relative Frequency (%)</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>53.5%</td>
<td>Overdrawn Bank Account</td>
</tr>
<tr>
<td>32.6%</td>
<td>Mail Order Companies</td>
</tr>
<tr>
<td>25.0%</td>
<td>Telephone Bills</td>
</tr>
<tr>
<td>24.7%</td>
<td>Rent Debts</td>
</tr>
<tr>
<td>22.5%</td>
<td>Cellphone</td>
</tr>
<tr>
<td>21.9%</td>
<td>Car Loans</td>
</tr>
<tr>
<td>21.2%</td>
<td>Real Estate</td>
</tr>
<tr>
<td>21.6%</td>
<td>Other Loans</td>
</tr>
<tr>
<td>20.9%</td>
<td>Consumer Credit</td>
</tr>
<tr>
<td>18.0%</td>
<td>Taxes/Fees</td>
</tr>
</tbody>
</table>

25 The overdrawn bank account in Germany is often combined with the so-called disposition credit. The unsecured disposition credit allows the customer to overdraw on a bank account up to the limit set by the bank. The interest rates vary; e.g., in 2007 the mean interest rate was 11.25 per cent. Compared with credit cards, which are not so popular in Germany, the disposition credit is used more often. In 2005 they did add up to €18.8 billion. Deutsche Bundesbank, Monatsbericht August 2007 (Frankfurt am Main, 2007) 33; Schufa Holding AG, Schulden-Kompass 2006 (Wiesbaden, 2006) at 75.

26 Some of our further analyses conclude that this kind of debt was often made by our female respondents, while car loans were much more popular among the male debtors. G. Lechner and W. Backert, above n 9, at 11.
five in total, and more often quoted by the younger members of our sample. Medical debts are rarely mentioned—with 9.1 per cent of mentions—which may be another indicator of the different weight of debt caused by medical problems in Germany in comparison with the United States. But some of the bank debt (for example, overdrawn bank accounts) may have been used to pay medical bills before initiating insolvency proceedings.

Table 13.1 above shows the range in the amounts owed by our respondents. The median value was been €20,000 and €40,000, and the modal value was between €10,000 and €20,000. The median income in our sample is around €1,200 per month. It is evident that many debtors are confronted with a total debt that they are unable to repay with their own means.

On the other hand, however, partial instalments negotiated by debt counselling agencies would be possible and sensible in some of the cases. German creditors often seem to let their debtors slip into private bankruptcy intentionally instead of being satisfied with partial repayment. This behaviour is rarely in the creditors’ interest. At the beginning of the bankruptcy proceedings there is a distribution of the remaining property to the creditors. Our respondents say that in 65.2 per cent no money or other valuable goods were distributed to the creditors, in 11.7 per cent there was a distribution, and finally 23.1 per cent of the debtors claim that they do not know if any money was given to the creditors. The findings show that in most of our cases there is nothing of value or money left that can be given to the creditors—there is no property to be distributed.

It is interesting that a high number of people state that they do not know if there was money distributed. Among the debtors themselves there is often not much knowledge about the details or the law of bankruptcy proceedings. This should be a topic for future research.

During the period from filing until discharge is reached—six years according to the German insolvency law—the debtor is required give that part of his income that is higher than the attachment-exempt limit (Pfändungsfreigrenze) to his creditors. However, in most households, there is no money left and no payments are made to the creditors. In our data only roughly 20 per cent of the debtors pay money to the creditors at all. In 80 per cent of the cases no payments are being made. The so-called Nullinsolvenz (zero insolvency), which was intended to be an exception by the legislator, seems to be quite normal in reality! From the 279 debtors in our sample that pay a certain amount, the first quarter pays less than €30 per month, and the next quarter less than €100 monthly. The last quarter pay sums between €250 and €1,000 monthly.

As noted above, it often takes some time to get into a serious debt problem. Over 50 per cent of our respondents accumulated the majority of their debts before the new millennium. Considering the fact that our questionnaire was sent to people who filed for bankruptcy in the years 2005 and 2006, the affected households carried their debt load for at least five years before filing. In 25.5 per cent of

27 G. Lechner and W. Backert, above n 24, at 128.
the cases the origin of the debt arose about 10 years ago. In addition to the fact that it takes time for the development of a debt crisis, there are other explanations for the long-lasting overindebtedness. First, private bankruptcy is seen to be the last resort, only taken when no other possibility is left in the end. Second, until the amendment in the year 2001, there was no or little chance for penniless debtors to institute private bankruptcy proceedings. Since 2001 and the deferral of court costs, the numbers of filings have increased significantly. Deferral of court costs was claimed by 81.9 per cent of the respondents to our survey. Third, bankruptcy proceedings cannot begin until an appropriate authority, usually by a debt counselling centre or an attorney at law, has affirmed that out-of-court settlement efforts have failed. If a debtor cannot afford a law firm, he is reliant on the debt counselling centre with often long waiting times. It has been previously reported that there is a correlation between the number of filings for bankruptcy and the quantity of debt counselling available in the federal states of the former Federal Republic of Germany.\textsuperscript{28}

VI. LIVING WITH OVERINDEBTEDNESS IN GERMANY

What are the consequences of living with debt in a country like Germany? First, many assets are likely to be lost. Their bank account has been attached for 46 per cent of our respondents, 36.6 per cent of our respondents have lost their bank account entirely, and in 38.2 per cent of cases a garnishment of earnings has taken place. Living without a bank account in a modern society with increasingly cashless payment transactions causes problems and costs, and the garnishment of earnings may lead to trouble with the employer, or eventually even cause the loss of the job. The home of our respondents, the place for family and living, was affected as well. In 14.5 per cent of the cases the home was taken by action of possession, in 13.3 per cent the power supply was cut off, and in 10.6 per cent action for possession against the tenant was filed. In 9.2 per cent of our cases, the car of the affected persons was taken by creditors, and another 21.4 per cent sold their car to raise funds to pay debts. Being without a car is a problem you can deal with if you do not need the car for work purposes, but in car-crazy Germany it may mean more than only losing a part of your mobility.

Overindebtedness affects quality of life in other important ways as well. In Germany it has a seriously negative influence on personal relations and on the family. In our survey, 23.4 per cent of the respondents claimed that as a consequence of debt problems their marriage was dissolved or their relationship split up. On the basis of a question used in the US Bankruptcy Project, we asked our respondents if the problems with money had negatively affected their children. In nearly half of the households with children, the financial problems had a

\textsuperscript{28} G Lechner and W Backert, \textit{Dynamik des Verbraucherinsolvenzverfahrens: Regionale Disparitäten und aktivierende Wirkungen} (BMFSFJ, Bonn, 2005).
negative influence on the children reared in these households. This tendency gains relevance with the number of children living in these households—households with more children more frequently state that the debt problem negatively affected the children.

Moreover, as a result of overindebtedness, many households could no longer afford several activities or household items. Holidays—the Germans’ favourite hobby beside their cars—were cancelled in roughly 90 per cent of cases. In responding to other questions, 76 per cent no longer went out for a meal, 73 per cent no longer attended public events, roughly 60 per cent no longer bought high-quality food, 52 per cent did not visit the cinema, 51 per cent stopped visiting theatres or museums, roughly 50 per cent cut back their expenses on clothes, 46.7 per cent cancelled their fitness studio membership, and 30.1 per cent terminated their cellphone contract. Nearly half (46.8 per cent) of our respondents could no longer afford a car, and 44.3 per cent cancelled their magazine subscriptions. A lot of basic social activities, participation in social life, and consumption become out of reach for the affected households.

In addition to these cutbacks in social life and consumption, our respondents tried to increase their income or spending power; 33 per cent borrowed money from their parents, 22 per cent borrowed money from friends, 28.1 per cent claimed that they worked illicitly to increase their income, and 23 per cent worked overtime.

Cutbacks in nutrition seems to us a particularly problematic consequence of overindebtedness. Less expenditures on high-quality food and reduced expenses for food seems to be one of the most popular ways of reducing costs and saving money for the overindebted households. Debt problems may directly lead to health problems as a consequence of malnutrition. This may specially be a problem for 9.6 per cent of our respondents who reported that addiction to alcohol, medications or drugs contributed to their debt problems.

In Germany living with overindebtedness means a reduction in social contacts, reduced social inclusion and it often means living life near the poverty line. Overindebtedness causes family problems and seems to be an endurance test for relationships and marriages. The children in the debtors’ households are often negatively affected. Living with financial failure of course also means reduced access to consumer goods and in parts it implies exclusion from modern monetary transactions.

VII. CONCLUSION

Since 1999, Germany has had a new legal way out of overindebtedness. With the amendment in 2001, the InsO has been adjusted to the financial and social situation of the penniless debtors. As a consequence the numbers of filings have started to increase. The German InsO in its current form is a step in the right direction, but there are still improvements needed.
One of the basic ideas of the German insolvency statute is to find a balance between the creditors and the debtors. During the six years of the period of good conduct (Wohlverhaltensperiode), the debtors are required to repay as much of their debt as possible and without any unreasonable demands. As our findings point out, most of the debtors’ households are unable to even pay a small sum to the creditors. It has to be questioned whether there is much sense in a six-year-long period of good conduct (Wohlverhalten) before discharge from remaining debts is allowed. Why should people be kept under financial ‘probation’, when there is no recognisable output for creditors, and there is evidence of poor quality of life for debtors?

A second question deals with the requirement that out-of-court settlements be attempted before filing for bankruptcy in Germany. The deferral of court costs makes private bankruptcy accessible for the debtors, but because of the required debt settlement efforts at present the impecunious debtor’s access to the proceedings depends on the availability of debt counselling centres. The financing of more debt counselling centres has to be secured.

According to our findings, ‘lack of knowledge’, ‘no experience in dealing with banks’ and ‘loss of financial overview’ are very important reasons for overindebtedness and bankruptcy. Finally, we want to emphasise that in future education and information, both in the schools and for mature consumers, will be needed for dealing with the problem of overindebtedness in Germany.
Elderly Consumer Weakness in ‘Withholding Credit’

JOHANNES DOLL*

1. INTRODUCTION

ELDERLY PEOPLE HAVE always had problems in getting access to credit. But in Brazil, banks are suddenly not only offering special credit for the elderly, but they are even persuading older people through a variety of techniques to obtain credit they do not necessarily need. Why might this be?

The growing interest of banks and the economy in the elderly is relatively new and has to do with the fact that, in Brazil, currently people aged over 60 are the fastest growing section of the population. But it is not only their number which makes the elderly of interest for the economy; also the fact that most of them have a small, but regular income with their pension. In 2004, the government created the legal possibility for people who receive a pension from the Institute of Social Security (INSS) to obtain credit and to repay the amount by charging directly the pension.1 This ‘withholding credit’ had an incredible success. From September 2004 to December 2007 about 9 million people, more than one third of all pension recipients, had taken at least one credit.

* We would like to thank Iain Ramsay, Johanna Niemi-Kiesiläinen and Bill Whitford for the kind invitation to participate in this book. Our thanks go to the PROCON-São Paulo, in the person of Marli Sampaio, responsible for the empirical study in São Paulo. We thank the international and interdisciplinary research group in Porto Alegre, which has carried out the empirical study in Porto Alegre and deepened the interdisciplinary aspects of understanding withholding credit to elderly people (Caroline Stumpf Buaes, Cristiano Schmid, Roberto René Lopes, Alexandre Ferreira, Rubia Poletto, Ana Carolina Souza, Milagro Traverso, Florencia Chaumet and Maria Luiza Jobim). The English text was written by Johannes Doll, who accepts responsibility for all errors. We thank Fabio Morosini and Lucas Lixinski for the correction of the English version. Thanks to the University of Siegen, Germany, for the invitation as visiting lecturer, offering the conditions in which to conclude this Chapter. The research acknowledges the financial help of the Research Foundation of Rio Grande do Sul-FAPERGS.

1 To be precise, not all pension recipients are elderly people, i.e., are 60 years or more (in Brazil as a developing country, the age limit for someone belonging to the elderly group is 60 years, according to the Second World Assembly on Ageing in Madrid, 2002). Because of an early start at work, people can retire earlier, especially in dangerous professions. But this is diminishing by the new legislation, and, in fact, most of the pension recipients are elderly.
Including the older population in the consumer world and giving them the opportunity to take credit is surely positive and part of social inclusion of the elderly. On the other hand, there remain a lot of questions: How are elderly people dealing with the credit? What do the elderly do with the money from the credit? Do they realize the consequences of the money taken? Do they have the ability to deal with the modern consumer world, including invasive and aggressive marketing? Is this credit really good for them? What are the risks for the elderly with the ‘withholding credit’? Is this a new form of exploitation of a special kind of group, which needs protective measures?

The present chapter addresses some of these questions. First, we provide an overview of the situation of elderly people in Brazil, especially those aspects relevant to their situation as consumers and credit users. Second, we discuss the ‘withholding credit’. Although created only in 2004, there have been many modifications since then, illustrating the problems with this form of credit. Third, we present the data from two studies, one in São Paulo, one in Porto Alegre, which indicates the characteristics of people who contract this credit, why people are seeking this money, and what consequences this kind of credit might bring to the elderly. Finally, the conclusion highlights the difficulties and particular risks in this market and the legislative challenges in dealing with the elderly as a new consumer group. This situation makes necessary legal and educational measures which might be helpful, especially to older people, to deal with the ‘crédito consignado’, the ‘withholding credit’.

II. ELDERLY PEOPLE IN BRAZIL

A. Brazil—an Aging Nation

Brazil was known, for a long time, as a young nation. But the passage from a ‘young’ to a ‘mature’ country has happened very quickly, much faster than in other countries. In the 1960s, Brazil was truly ‘young’, with a very high fertility rate (6.2 children per woman), a low life expectancy (51.64 years), a large number of children (0–14 years; 43 per cent of the population) and few older people (> 60 years; 4.7 per cent of population). This changed quickly in the second half of the 20th century. A very strong reduction of the fertility rate (1960: 6.2; 2006: 2.00 children per woman) and of child mortality rates (1960: 121.08 per cent; 2006: 24.9 per cent) diminished the group of the younger people and increased the life expectancy.

By 2006, life expectancy had gone up to 72.3 years and the proportion of older people had more than doubled. At this time, Brazil had more than 19 million people over 60, representing 10.2 per cent of the population.2 The elderly con-
stitute today the fastest growing population group in Brazil; in 2050, it is estimated there will be about 39 million elderly people.

B. Specific Legislation Concerning the Elderly

But the myth of the young nation continues. Only small groups of social gerontologists and geriatric doctors noticed the signs of the demographic shift in the 1960s.\(^3\) There were some efforts from the Ministry of Social Security to start thinking about public policies for the elderly and there were initial activities like senior groups in some institutions.\(^4\) But it was only in the 1990s that the impact of the increasing size of the elderly group started to be noticed by a broader public. In 1992 the Brazilian population was surprised by a large movement of retired people who took to the streets to proclaim their rights to pension adjustment.\(^5\) On the political side, we can see in these years the foundation of special councils (at the state and city levels) of the elderly, working for the implementation of public policies for the older part of the population.

The Democratic Federal Constitution of 1988 assured rights for the elderly in its Article 230. But only in 1994, after long and hard work by professionals and NGOs involved with the question of aging, that a special law for a policy for the elderly was created: Federal Law 8.842/94—‘Lei da Política Nacional do Idoso’ (Law of the National Policy for the Elderly).\(^6\) The objective of that law is to secure the social rights of the elderly by creating conditions to promote their autonomy, integration and effective participation in society. Despite the importance of that

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\(^3\) A Lopes, *Os desafios da Gerontologia no Brasil* (Campinas, SP, Alínea, 2000).


\(^6\) For details of the history and the participation of political institutions, NGOs and scientific associations on the law 8842/94, see Rodrigues, 2001.
law, most of the Brazilian population didn’t notice its existence and the mass media hardly mentioned the law. Public attention needed some more years to change. When nine years later in 2003 the Federal Law 10.741—‘Estatuto do Idoso’ (Elderly Rights Act)—was created, it was covered by all mass media, and there was even a soap opera about the need for protection of the elderly. The Elderly Rights Act follows the same spirit of the Law of National Policy of the Elderly, repeating many topics of that law. The difference is that the Elderly Rights Act has a more protective character, listing attitudes and crimes against the elderly that will be punished.\(^7\)

In these laws, there are no specific articles about the elderly as consumers or the provision of credit to elderly people. But the Consumer Code of 1990 mentioned the elderly, prohibiting in Article 39.IV the exploitation of the fragility and vulnerability of elderly people.\(^8\)

C. Financial Situation of the Elderly

For a long time, the image of the elderly was closely linked to poverty, which means older people had little importance in the consumer market and were not a target group for marketing and publicity. In Brazil, this situation changed in the 1990s, especially by the enlargement of social security benefits. In 1983, 19.1 per cent of the Brazilian elderly did not have any income. This level diminished to less than 12 per cent in 2003.\(^9\) There were mainly two measures which benefited the elderly, both inspired by the new Brazilian Constitution of 1988. The first was an amplification of the ‘Benefício de prestação continuada’ (continuing benefit), today called the ‘Benefício assistencial ao Idoso e ao Deficiente’ (support benefit for the elderly and handicapped person). Until 1993, this benefit was a quarter of the minimum wage for those aged 70 or more or handicapped people who did not have any other income. Law 8.742 of 1993 increased the benefit to the level of the minimum wage, today about US$215 (per month). The Elderly Rights Act of 2003 lowered the age for the benefit from 70 to 65 years.

A second measure was the increase in pensions for the rural population. Based on the Brazilian Constitution of 1988, an old age pension equal to the minimum wage was introduced for men (60 years or older) and women (55 years and older) if they can prove that they are rural workers, even if they did not contribute to the Social Security System. The extension of the pension system to the

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\(^7\) Besides the two principal laws for the elderly, there are many more specific laws, especially about health and social politics, at federal, state and municipal level. To consult, see, for example, <http://www.ufmg.br/3idade> and <http://www.pbh.gov.br/leisdeidosos>, accessed 4 July 2008.

\(^8\) CL Marques et al, Comentários ao Código de Defesa do Consumidor 2nd edn (São Paulo, Revista dos Tribunais, 2006).

rural population increased significantly the financial situation of the elderly in this area and guaranteed equal rights among men and women.\textsuperscript{10}

Pensions are an important part of the income of the elderly, but not the only one. Most men continue working after retirement, sometimes in the same job, sometimes starting a new career, mostly entering the informal labor market.\textsuperscript{11} The data from the PNAD 2006 (National Household Sample Survey) show that 32 per cent of the elderly population continues to be economically active, especially men. Analyzing the income of people over 60 years, we find that the highest amount comes from pensions and other contributions of the social security system (49 per cent), followed by income from labor (39 per cent). Smaller amounts come from letting (7 per cent) and other income (6 per cent).\textsuperscript{12}

To sum up, the financial situation of the elderly is not so bad compared to the general population. Many of the elderly were able to acquire their own small house or apartment during their lives, and even if the pension reform from 1999 established a ceiling and created more difficult conditions for retirement, the guaranteed and reliable pension, even though small, represents an important economic factor, not only for the elderly, but also for the families they are living with.\textsuperscript{13} The regular income of the elderly becomes especially important in an insecure and unstable labor market, marked by difficult access, informal work and unemployment for the younger generations.\textsuperscript{14} This general economic situation inverts the idea that the adult generation is taking care of the elderly. In Brazil, in many cases, the older members of the family take care of the household economically. The census of 2000 showed that 62.4 per cent of the elderly are responsible for the household, a number that had increased since the last census, and 20 per cent of all Brazilian houses had an older person (60 or more years) as the main breadwinner.\textsuperscript{15} Considering that the population aged 60 or more years represented in 2000 just 8.6 per cent of the general population, they are very highly represented in the function of being head of the family. Living together in Brazil is generally of advantage for both the elderly and the younger generation; it was correlated with a better health situation of the elderly and general benefits for the younger generation.\textsuperscript{16}


\textsuperscript{11} J Doll, ‘The situation of elderly workers in Brazil’ in TALES, Third Age learning studies, Proceedings of the XII International Seminar (Canada, Saskatoon, 2002).


\textsuperscript{13} See Camarano, n 9 above.

\textsuperscript{14} U Beck, Schöne neue Arbeitswelt (Frankfurt/Main, Campus Verlag, 1999).


III. ‘CRÉDITO CONSIGNADO’

The rapid increase in the number of older people and, with that, the number of pension recipients and their relatively low, but stable and secure income turned this population group into a new and interesting target for the economy and, especially, for the consumer credit business. Just to give an idea of the size of this market, in November 2007 there were about 19.9 million pensions in Brazil, with an average value of about R$856.00 (US$ 490).\(^{17}\)

In 2003, the President of Brazil signed a Provisional Presidential Decree (\textit{Medida Provisória} 130/2003), later transformed into Federal Law 10.820/2003, creating the possibility of a ‘withholding credit’ (\textit{crédito consignado}), for the recipient of pensions paid by the Institute of Social Security (INSS), a kind of specially regulated credit, based on the pledge of the pensions. The INSS created in 2003 a normative instruction (\textit{Instrução Normativa} INSS/DC N. 97, 17/11/2003) for this kind of credit, the final regulation and implementation occurring in May 2004.

The basic idea of this credit is to give pension recipients, most of them elderly, the possibility to access credits in a regulated form with advantages for the credit taker—lower interest rates—and for the credit institutions—lower risk. The principal rules are a limitation on the length of the credit (until January 2008—36 months, now—60 months) and the monthly repayments which could not exceed 30 per cent of the net benefit (now 20 per cent). The credit institutions, interested in offering this service, have to make a contract with the Institute for Social Security (INSS).\(^{18}\)

It was expected that the credit institutions would offer a lower interest rate because of the very low risk they take, considering that the repayment is deducted from the pension and passed directly from the INSS to the credit institution. The only possible risk for the credit institutions are the death of the credit taker or fraud, a risk which is calculated to be between 2.00 to 2.50 per cent.\(^{19}\) In fact, the interest rates were a little lower than other forms of credits considering the very high interest rates in Brazil: overdraft credit about 141 per cent a year, personal credit 52.5 to 55.8 per cent a year.\(^{20}\) But even so, in June 2006, the National Council of Social Security saw the necessity of declaring a

\(^{17}\) Data from the monthly report of the INSS (Instituto Nacional de Seguridade Social—National Institute for Social Security), accessible at \langle\text{http://www.mpas.gov.br/pg_secundarias/previdencia_social_13_05.asp}\rangle, accessed 10 January 2008.

\(^{18}\) The list of the banks and the interest rates can be consulted on the home page of the Ministry of Social Security. See \langle\text{www.previdencia.gov.br}\rangle, accessed 4 July 2008.

\(^{19}\) In the news story from the newspaper ‘Folha de São Paulo’, online version, from 30 June 2006, the risk of insolvency was considered to be about 2.5 per cent, following a research from the Brazilian Central Bank. See: \langle\text{http://www1.folha.uol.com.br/folha/dinheiro/ult91u109027.shtml}\rangle, accessed 4 July 2008. In a model calculation from the Cacique Bank, the impact of insolvency and risk was calculated by 2.00 per cent.

\(^{20}\) The interest rates refer to April 2007 and are based on data from the National Bank. See: \langle\text{www.bacen.gov.br.}\rangle accessed 16 July 2007.
ceiling of 2.9 per cent monthly on interest rates. Since then, the ceiling diminished a little because of general falls in interest rates: currently it is 2.64 per cent monthly, which means 36.66 per cent a year.

The ‘withholding credit’ attracted a high number of elderly people, stimulated by very aggressive marketing strategies. Besides the regular publicity in the banks, very well known elderly TV presenters were hired to sell the idea of a ‘crédito amigo’, a friendly credit. To increase the attractiveness of the credit, the publicity went beyond the boundaries of the public and private (friendly credit), used specific fears of elderly people (loneliness, health problems) and invoked authority figures. The tendency to exaggerate the positive aspects and conceal important other information resulted in some lawsuits and class actions.21 Besides these marketing strategies, personal contact is another central tool used by these companies. In some streets of Porto Alegre, where there are many banks, financial institutions and commerce, it is quite impossible for an older person to pass without being asked if he or she would not like to make a credit.

The necessity of the pension recipients, the advantages of the new credit and the aggressive publicity showed results. In the first seven months, the banks had lent in the system of ‘withholding credit’ about R$ 11.5 billion (about US$ 6.5 billion) in 6.8 million contracts. The last data from December 2007 showed a value lent of nearly R$ 30.6 billion (about US$ 17.3 billion) in about 23.6 million contracts.22 Considering that there are a little less than 9 million people who contracted a ‘withholding credit’, we can see that more than a third of all recipients of pensions from the Institute for Social Security (INSS), about 19.9 million pensions, had contracted at least one loan. Most had contracted two or more credits.

But not everything was fine with those credits. There were several problems from the beginning, which required the Institute of Social Security to determine new rules, trying to prevent abuses by credit contractors, to protect consumers by regulating bank practice and preventing frauds. Just to give an idea: from January 2005 to January 2008, the rules on the ‘withholding credit were changed eight times.23 Most are to regulate bank practices in order to protect credit takers. Some of the regulations show that there were tendencies of abuse in bank practice. In order to get the highest number of clients as possible the banks made it very easy to contract a credit, opening possibilities for misuse.

23 The actual version of the Regulation, the changes and the announcements of the changes in the Internet can be seen on the homepage of the Ministry for Social Security: <www.previdencia.gov.br>, accessed 4 July 2008.
and fraud. For example, although the regulations allowed contracting only in a written form or in a secure electronic manner, contracting by phone happened. This was an open door to fraud. Criminals asked the basic information on the phone from the elderly and, after that, made a ‘withholding credit’ in their name.24 So in September 2005, contracting by phone was expressly prohibited. Currently, considering the high number of frauds, there is a proposal to prohibit making a ‘withholding credit’ in another state than the residence of the pension recipient and to require a bank account where the loan money should be disbursed.25

In a similar way, in July 2005, more than one year after starting the credit, the INSS had to impose a duty of information on the banks. For many of the elderly credit users, it was hard to understand what they were in fact paying for. In order to avoid concealing the real price that credit users are paying for the credit, the banks must provide the interest rates per month and per year, contracting taxes, tributary and other taxes, the entire value, the number and the period of the installments. In May 2006, contracting taxes were prohibited. In June 2006, a ceiling on interest rates was introduced.

Two topics in particular changed several times, showing the difficulties the INSS had to deal with. The first is the length of the period which credit users have to pay back the credit. Initially, it was 36 months. In July 2005, it was deregulated, giving the banks the freedom to define the repayment period. In September 2005, the period of 36 months was reestablished and remained until January 2008, when it was extended to 60 months. At the same time, the limit of 30 per cent of the net benefit that can be used for repayment was lowered to 20 per cent, out of concerns about the possibility of overindebtedness of the elderly. The second complicated point was the use of credit cards. In July 2005, there was introduced the possibility of using the ‘withholding credit’, up to a value of 10 per cent of net income, to finance a credit card, following specific rules. But in November of the same year, this possibility was cancelled, because of higher interest rates on credit cards and the risk of overindebtedness of the credit takers. A special study group on the use of credit cards was instituted, and in the latest regulations from January 2008, the use of a credit card is allowed, again, but with specific interest rate ceilings, controls on the charge for the use of the credit card and prohibiting an annual fee.26

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24 There were, and still are, specialized criminal groups using the different possibilities of the ‘withholding credit’ to get the money from the pension receivers. See: <www.previdencia.gov.br>, accessed 10 January 2008.

25 From April to October 2007, there were 4,300 denounces, almost half of them concerning realization of ‘withdrawing credit’ with financial institutions in other states as the residence of the pension receiver, so mostly frauds. Based on this, the council of the INSS proposed in November 2007 new security measures, but in the latest instruction from January 2008, they were not included. See: <www.previdencia.gov.br/agprev/agprev_mostraNoticia.asp?id=28887&ATVD=1&xBotao=1> accessed 10 January 2008.

The continuing changes in the rules of the ‘withholding credit’ are surely a problem. On one hand, it reflects a high sensibility of the INSS, trying to adjust the rules to problems experienced by credit users. But the changes are problematic, in particular for the elder population. Although the newest information can be accessed by the homepage of the Ministry of Social Security, most of the elderly in Brazil don’t use a computer and the internet, especially people with lower income and limited schooling. So the impression remains that an important instrument to include elderly people in the consumer world—the ‘withholding credit’—was introduced in an overhasty way. This impression is reinforced by the fact that it was only in June 2005, more than a year after the implementation, that the population was informed about the ‘withholding credit’ and its rules in a Brazil-wide television and radio campaign.

Considering the immature version of the first ‘withholding credit’, it was up to consumers to fight for their rights. An important partner in this journey was, and is, the PROCON of São Paulo, a state department of consumer protection and mediation. In this function, the PROCON is in contact with problems of the consumer. Concerning the ‘withholding credit’, the department registered very early the following problems: lack of clarity in offer and information, lack of transparency in marketing and publicity, non-presentation of the contract to the contractor, abusive terms, unsolicited sending of credit cards, contracts by phone, even after the prohibition. Another helpful institution was the public attorney, which addressed the exaggerated publicity for the ‘withholding credit’.

Besides the problems with the operational part of those credits, there was another problem—dealing with the consequences of the credit. At first sight, it might be very good to have a little more money available. But the credit has to be paid back, and when the monthly installments arrive, people may regret having taken a credit. After all, the amount to be paid back is always greater than the money received before, a situation described by Marques as a credit hangover.

IV. ‘WITHHOLDING CREDIT’—DATA FROM ONGOING RESEARCH

In order to get more information about the people who are using withholding credit and the consequences of this credit in their lives, a study was undertaken.

27 Complaints and problems can be communicated by a special phone or by e-mail to the INSS. For some time, there was a list of these complaints at the site of the INSS. See: <http://www.previdencia.gov.br/agprev/agprev_mostraNoticia.asp?id=23142&ATVD=1&xBotao=1>, accessed 4 July 2008.
28 See Doll, above n.11.
29 There are other PROCONS in other states, too. But the PROCON of São Paulo showed until 2007 a special engagement in the protection of the consumer of the ‘withholding credit’. See: <www.procon.sp.gov.br>, accessed 4 July 2008.
31 Marques used this expression borrowed from the article in the weekly magazine ‘Veja’, ‘Ressaca de crédito’ (The credit hangover) from Carina Nucci, 18 May 2005.
by the PROCON-SP, and by a mixed research group from the Federal University of Rio Grande do Sul, from the School of Education and the Law School.\textsuperscript{32} The questions to be answered were:

1. What are the characteristics of people who contract this credit?
2. What are the reasons for people contracting the ‘withholding credit’?
3. What are the consequences of the credit in the everyday life of these people?

The research was carried out in two major cities, São Paulo and Porto Alegre. For the data collection, a questionnaire collected personal data, family structure, housing and financial situation, whether individuals had a ‘withholding credit’. Considering that many elderly people in Brazil have problems with the written language, the questionnaire was filled in by trained interviewers. Concerning the subjects to be interviewed, we supposed that the impact of the ‘withholding credit’ might be strongest in the lower middle class. The very poor hardly get access to the credit, because only pension recipients can make a ‘withholding credit’. On the other hand, elderly people with high incomes were expected to have sufficient knowledge to understand and deal with credits. So for the research, places which elderly people from the lower middle class might frequent were chosen. In São Paulo, the interviews were carried out in a center for the elderly in 2006/2007 and in Porto Alegre in different senior groups during 2007. Over all, 215 elderly people were interviewed, 125 in São Paulo and 90 in Porto Alegre. Of those interviewed, 81 (37.7 per cent) indicated that they had made at least one ‘withholding credit’. This data is similar to the general data, where more than one third of the pension recipients had made a credit.

A. Characteristics of People with ‘Withholding Credit’

The interviewed groups of elderly individuals had an average age of 69 years and showed very typical characteristics of older people in Brazil. Considering marital status, we found two big groups, married people or those living in a stable relationship (39.1 per cent) and widows (39.5 per cent). Smaller are the groups of separated or divorced people (11.6 per cent) and the unmarried (9.8 per cent). Relating to the families, most of them have children and grandchildren and, considering that the elderly people of today had their children at a time when Brazil had a very high fertility rate, it is to be expected that there will be large families. In fact, the largest group (45.6 per cent) is that with three or four children, followed by the group with five or six children (34 per cent). The group with few children is smaller (one or two children: 16.3 per cent), while the number of really big families with seven or more children is very small (2.3 per cent).

\textsuperscript{32} The study counts on the support of PROCON-SP, Federal University of Rio Grande do Sul, School of Law and School of Education, and FAPERGS (Foundation for Support to Research in Rio Grande do Sul).
This might also be because the study was conducted in cities: in the countryside, big families are more common. In the next generation, the numbers are lower, but still quite high, considering that most of the elderly have seven to 10 grandchildren (40.5 per cent), or even 11 to 15 (30.7 per cent).

Almost all the people interviewed are homeowners (83.7 per cent). Very few live in rented houses (5.1 per cent) or houses owned by relatives or others (7.4 per cent). This is very normal in Brazil, where 91 per cent of the population live in houses, of which 75 per cent are also the owner. In most cases, the elderly are living with other family members, while 21.4 per cent are living alone. The number of elderly living alone in Brazil is lower than in other countries, but it is increasing. In the general population in 1985, there were only 7.1 per cent of the population alone; in 2006, this number went up to 15.6 per cent. In general, the households of the elderly are a little smaller: 26.5 per cent are living with only one other person, the same number is living in households with three people, while only 11.6 per cent of the interviewed people were living in households with five or more people.

The income is also similar to the general population, almost a third have a net income of less than the minimum wage, about US$215 (29.3 per cent), while 31.6 per cent earn between US$215 and US$430. A slightly smaller group have between US$430 and US$860 (27.9 per cent), but there is only a very small group with a higher income: 1.9 per cent of the interviewed had an income with more than US$2,150. The income of the people interviewed is a little less than in the general population, where 14.7 per cent of the households earn less than the minimum wage, 23.3 per cent earn between US$430 and US$860 and 8.6 per cent earn more than US$2,150. But it is possible to see that the researched group reflects Brazilian reality, and the smaller income confirmed the expected selection of elderly from the lower middle class.

The formal education of the elderly is generally lower than that of the younger population. When the elderly were of school age, the Brazilian school system did not have its contemporary scope, so many elderly did not go to school, or when they did, mostly only for a short time. The collected data confirmed this expectation: among the participants, there are 18.6 per cent without any schooling, and 47.9 per cent had been in school from one to four years, a very reduced schooling, which unfortunately is a correct representation of the Brazilian reality. We can say that from the participants in that study, 66.5 per cent had a quite poor schooling, which suggests that their abilities in mathematics and

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35 Data from PNAD 2006, ibid.
36 The study *Idosos no Brasil*, realized by the Foundation Perseu Abramo and the Social Service of Commerce, came to similar, even a little higher results: 70 per cent of the 2,136 interviewed elderly had no or at most four years of schooling. See GA Santos et al, ‘Escolaridade, raça e etnia: elementos de exclusão social de idosos’ in AL Neri (ed), *Idosos no Brasil: vivências, desafios e expectativas na terceira idade* (São Paulo, Editora Fundação Perseu Abramo, Edições SESC SP, 2007).
reading might be compromised.\textsuperscript{37} This is, of course, important information considering the abilities necessary to understand credit contracts.

The health situation of the participants is mostly regular (41.9 per cent), based on the opinion of the elderly themselves. But there are more people with a tendency to good than to bad: 27.4 per cent considered their health situation as good, 8.4 per cent even as very good. On the other side, 15.8 per cent speak of problems and 6.5 per cent consider their health situation very bad.

Looking closer at the data, we can find some differences between the group from São Paulo and Porto Alegre. The average age is almost equal, but the group from Porto Alegre is formed mainly by women (90 per cent). In São Paulo, there are also more women (65.6 per cent) than men, but the difference is not so strong.\textsuperscript{38} This has consequences, principally on the marital status, because elderly women have a higher probability to be widows than men, because of the higher life expectancy of women and the lower marriage age. In the present group, it is the same, so in the group of Porto Alegre, the largest group is widows (55.6 per cent), while in São Paulo, the group of those married or living in stable relations is the biggest (50.4 per cent).

Beside the gender differences, the average of the group of Porto Alegre seems to be in a slightly better situation. There are more people with a better income, with a higher schooling, and with a better health status (Table 14.2). And they have fewer children and grandchildren, too. In São Paulo, almost all the group has between three and six children (94.4 per cent) and also a lot of grandchildren (from seven to 15 grandchildren: 99.2 per cent). In Porto Alegre, there are fewer children and we have more variation: one to two children: 31.1 per cent; three to four children: 37.8 per cent; five to six children: 21.1 per cent. And also in the next generation, where we find in Porto Alegre fewer children, 20 per cent have only one to two grandchildren.

Analyzing the socio-demographic data, the interesting question is if we can find differences in the profile of people who had contracted a credit, comparing with people who didn’t. Generally, it is possible to say that the differences occur only in some of the socio-demographic characteristics, and they are very small.

In schooling and income, there is a small, but significant difference, showing a U-function. The middle-group in income and schooling is more represented in

\begin{footnotesize}
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\textsuperscript{37} In the study \textit{Idosos no Brasil}, from the 89 per cent of the elderly with less than eight years of schooling, 23 per cent were illiterates and from the 66 per cent who can read, 26 per cent considered it a difficult activity. See: <http://www2.fpa.org.br/portal/modules/news/index.php?storytopic=1642>, accessed 4 July 2008.
\end{footnote}

\begin{footnote}
\textsuperscript{38} The senior programs are frequented almost exclusively by women, which explains the gender distribution. But, in relation to the present research, this might not be so problematic considering that the differences concerning the ‘withholding credit’ are very slight, comparing men to women, as shown by \textit{Idosos no Brasil}: 77 per cent declared that they just had heard about the ‘withholding credit’ (men: 82 per cent; women: 73 per cent), 23 per cent said that they had contracted this credit (men: 25 per cent; women: 21 per cent). From the 23 per cent with a credit, 19 per cent had done it for their own needs (men: 22 per cent; women: 17 per cent) and 4 per cent had done it to help someone in the family (men: 2 per cent; women: 4 per cent). See: <http://www2.fpa.org.br/portal/modules/news/index.php?storytopic=1642>, accessed 4 July 2008.
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the group of credit takers, while the poorest and the richest, both in income and education, are more represented in the no-credit-taker group. Another small difference can be found in the marital status: people who are married or living in a stable relationship are less represented in the credit-taker group, while unmarried or widowed persons are more often in the credit taker group (see Table 14.3).

And there is a small difference in the health situation as well: credit takers tended to evaluate their health situation as being a little worse than the no credit

Table 14.2 Income, schooling, and health situation, comparing São Paulo (SP) and Porto Alegre (POA)

<table>
<thead>
<tr>
<th>Income</th>
<th>Schooling</th>
<th>Health situation</th>
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<tbody>
<tr>
<td></td>
<td>SP % POA</td>
<td>SP % POA</td>
</tr>
<tr>
<td>Don’t know</td>
<td>0.8</td>
<td>24.0</td>
</tr>
<tr>
<td>Without income</td>
<td>0.0</td>
<td>29.6</td>
</tr>
<tr>
<td>Up to US$215</td>
<td>43.2</td>
<td>27.2</td>
</tr>
<tr>
<td>US$215–430</td>
<td>30.4</td>
<td>7.2</td>
</tr>
<tr>
<td>US$430–860</td>
<td>21.6</td>
<td>8.0</td>
</tr>
<tr>
<td>US$860–1,495</td>
<td>3.2</td>
<td>2.4</td>
</tr>
<tr>
<td>US$1,495–2,150</td>
<td>0.8</td>
<td>1.6</td>
</tr>
<tr>
<td>More than 2,150</td>
<td>0.0</td>
<td>100.0</td>
</tr>
<tr>
<td>Missing data</td>
<td>0.0</td>
<td>2.2</td>
</tr>
</tbody>
</table>

Source: Research.

Table 14.3 Income, schooling, and health situation, comparing people with credit and without it (no credit)

<table>
<thead>
<tr>
<th>Income</th>
<th>Schooling</th>
<th>Marital state</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Credit</td>
<td>No credit</td>
</tr>
<tr>
<td></td>
<td>%</td>
<td>%</td>
</tr>
<tr>
<td>Don’t know</td>
<td>0</td>
<td>0.7</td>
</tr>
<tr>
<td>Without income</td>
<td>0</td>
<td>0.7</td>
</tr>
<tr>
<td>Up to US$215</td>
<td>26.3</td>
<td>31.1</td>
</tr>
<tr>
<td>US$215–430</td>
<td>36.3</td>
<td>28.9</td>
</tr>
<tr>
<td>US$430–860</td>
<td>30.0</td>
<td>26.7</td>
</tr>
<tr>
<td>US$860–1,495</td>
<td>3.8</td>
<td>8.2</td>
</tr>
<tr>
<td>US$1,495–2,150</td>
<td>2.5</td>
<td>0</td>
</tr>
<tr>
<td>More than 2,150</td>
<td>1.3</td>
<td>2.2</td>
</tr>
<tr>
<td>Missing data</td>
<td>0</td>
<td>1.5</td>
</tr>
</tbody>
</table>

Source: Research.
takers. At this point, it is not possible to confirm a relation of causality, so it is possible that people with bad health conditions need more credit to undergo the necessary medical care. Or it might be that worrying about credit causes one’s health to deteriorate.

In summary we can say that the interviewed groups are within the general characteristics of elderly Brazilian people. They are integrated in their families, they have some stability by owning their houses and they have a regular, but small income from their pensions. Regarding their schooling, most of them have very little, almost one third are functionally illiterate and two thirds have serious problems with reading. This is important information to be considered in relation to financial contracts. During the interviews, it became clear that most of the elderly did not have a very precise idea about the credit and its specification. Normally, they considered only the time they would need to pay back, but they had a very confused idea of the advantages or disadvantages of the ‘withholding credit’.

B. Reasons for Using Credit

What are the reasons for pension recipients taking credit? For what purpose are they using the money? As we can see in Table 14.4, there are several quite different purposes.

The first and most frequent reason given is that they are doing it for other family members. On one hand, that makes sense: knowing the high costs of credit in Brazil with interest rates from 55 per cent up to 140 per cent a year, it is much cheaper that parents or grandparents take the credit with an interest rate of 36.66 per cent a year and the person really needing the credit gets the money from them. When everything goes fine, there is no problem. But in the end, the one who remains with the risk is the elderly person. In many cases, the younger generation with employment problems obtains a credit from their parents to open some sort of business. And on many occasions, they fail. In the

<table>
<thead>
<tr>
<th>For family members</th>
<th>Renovation</th>
<th>Debt</th>
<th>Disease</th>
<th>Basic needs</th>
<th>Acquisition of goods</th>
<th>Traveling</th>
<th>Funeral service</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cases</td>
<td>24</td>
<td>23</td>
<td>15</td>
<td>13</td>
<td>13</td>
<td>3</td>
<td>2</td>
</tr>
</tbody>
</table>

Source: Research.

Analyzing the self-evaluated health from very good (=1) to very bad (=5), we found the following data: credit taker: 2.93; no credit taker: 2.80.
end, the debt remains with the elderly. In one case, a woman told me during the interview: she made the credit because her son needed a car. He bought the car, but because of financial problems, he had to sell the car again. His mother will continue to pay for a car her son no longer owns for a year and a half.

The second reason, obtaining money for home improvements, is a very normal process. That people invest in better housing, in better life conditions, is a very healthy way to deal with credit. The third reason is more problematic: using the loan money to pay other debts. Again, it is understandable that the cheaper money of the ‘withholding credit’ is used to pay other more expensive debts. But we observed in the interviews that a certain number of people are in a cycle of continuing debt. Thus, when half of the ‘withdrawing credit’ or other credits are repaid, many banks make contact to say, that, if they want, they can make another credit. And the data confirm that some individuals are repeat borrowers. From the Porto Alegre group, 16 had only one credit, but 11 had made two credits, and 13 people had made three or more credits, and one person had made eight credits. So, changing one credit for another can be seen as a bad sign as an indicator for—beginning or ongoing—overindebtedness.

The mostly small income from pensions is, in many cases, not enough to afford basic needs. Especially if there is an exceptional expenditure, for example an illness, people need extra money. This is one of the main reasons why people take a credit, as can be seen in Table 14.4. But the most problematic reason for taking a credit is to pay for basic needs, which 16.3 per cent of the interviewed people mentioned. Because if people cannot afford the basic needs with their regular income, it will be even worse if that income will be cut to repay the ‘withholding credit’, which will diminish the pension up to 30 per cent, or, since 2008, up to 20 per cent.

Analyzing the reasons for making a credit, we can ascertain some reasons that are quite normal and make sense, such as taking a credit for traveling, acquisition of goods or renovation of the house. But there are other reasons we might worry about. So taking a credit for other people sounds very nice, but it creates risks and dependence that might be problematic, especially for elderly people. And looking at the data from our interviews, we can see that in most cases, the elderly are contracting the credit for someone else. In the group of Porto Alegre, 20 people made the credit for themselves, 11 for themselves and for another and 12 made it for another person. In São Paulo, 26 interviewees said that the credit was for them, while 11 did it for another person, mostly from the family. So we can say that in about 30 per cent of the cases, the credit is not for the elderly, but for another person. Finally the most problematic reason for taking a credit is to pay for basic needs, because this might be the beginning of a circle of needs and debts from which it is hard to escape and it leads directly to overindebtedness.

40 The question about the number of credits was included later, so there are no data about that question from the São Paulo group.
V. CONSEQUENCES OF THE ‘WITHHOLDING CREDIT’

The principal characteristic of the ‘withholding credit’ is that the repayment is deducted directly from the pension, which means that the received income will be lower for a good while. Until January 2008, this could be up to three years, and the deduction could be up to 30 per cent of the pension. To respond to the concern that this was too large a deduction the regulations were changed in 2008 to permit only a 20 per cent deduction but with the possibility of repayment over a period of five years.

If this deduction is planned in the family budget, there is no problem. But many elderly individuals are surprised by the reduction. From the 80 interviewed pension recipients who had taken a credit, 33 per cent said that they had to cut down on other expenses; most of them (58 per cent) did this on basic needs, for example, buying less or cheaper food. Others diminished the expenses in the health area, canceling the health plan or saving on medicine (12 per cent), others held back other payments (5 per cent) or, in one case, had to take a new credit in order to pay the first. There is no problem in diminishing the expenses in leisure activities or postponing new acquisitions, but it is problematic, when the cuts are in basic expenses (health, food) or lead to new credits and failing to make other payments.

How do the elderly evaluate the experience of the ‘withholding credit’? In this question, opinions were divided. For about one third of the credit takers (35 per cent), the situation improved with the credit, while for a smaller group, there was no change (24 per cent). But for the majority (41 per cent), the situation deteriorated with the credit. In this evaluation, the group of São Paulo was even more pessimistic: 54 per cent of those interviewed said that their situation got worse after the credit.

It is therefore understandable that a considerable group (42.5 per cent) wouldn’t repeat the experience of the ‘withholding credit’. Just to illustrate one of the reasons for this position: one woman related that she had taken the credit for her daughter, but she did not pay back the money, so that the mother remained in debt. But an even larger group would do it again (57.5 per cent). Maybe it is not exactly because they liked it, since many of those interviewed explained that in many instances there is no other way, and considering the different possibilities of credits, the ‘withholding credit’ offers the best conditions.

Reviewing the evaluation of the elderly, we can ascertain that the ‘withholding credit’ is in some cases a good opportunity to get access to credit. But for 41 per cent of the credit users, almost half of the group, the ‘withholding credit’ caused their situation to deteriorate. The problem is in many cases not the credit itself, but the small pensions and generally difficult economic situations, not solely for the elderly but also for their families. But even so, we have to consider that the credit opened a possibility of exploiting the elderly, partly by their own family members, partly from the banks that not only offer a credit, but persuade
the elderly with aggressive publicity and questionable marketing strategies to make a credit they might not always need and where they might not always have a clear notion what that credit means to their pensions for the next years.

VI. CONCLUSION

Analyzing the situation of elderly people in Brazil, the development and almost explosive expansion of the ‘withholding credit’ among pension recipients since 2004 and observing the data from an ongoing research with elderly people who had contracted this kind of credit, we ascertain that in a number of cases, the ‘withholding credit’ is a good and adequate possibility for elderly people to have access to credit in reasonable conditions, considering the Brazilian context. This is true, when the credit is used for certain objectives and when the credit taker is conscious of the financial consequences of the credit.

The ‘withholding credit’ offers an interesting way to include elderly people in present-day society, but it is also a very interesting object for the financial institutions, for the commerce and even for politics. Besides its lower interest rates as compared to most other consumer credits, it is an excellent bargain for the banks because of its very low risk. The payment comes directly from the Institute of Social Security, and thus the credit taker has no opportunity not to pay the debt. For business, elderly people with money are excellent consumers. And for the government, the injection of all the money lent to the pension recipients is excellent for the economy and, in some cases, this kind of credit is even used to resolve specific problems.\footnote{For example, the complaint of the Brazilian Tourism Business was answered by approving a special ‘withholding credit’ for the retired to buy tourist packages. See: <http://br.news.yahoo.com/s/11072007/25/economia-codefat-aprova-credito-consignado-viagens.html> accessed 13 July 2007.} The general strategy is using the low, but stable income of the retired to increase the national economy. The risk is that after a credit honeymoon surely will follow a credit hangover, especially when the repayment of the credit lowers significantly the already very low pensions. As we have seen with the data from the research, there is a considerable group, in our study of about 20 per cent, for whom the decrease of the pension means a reduction of basic needs such as food or medication. The impossibility of repaying the ‘withholding credit’ forces the elderly to alternatives, such as eating less, neglecting costs for health, and refinancing the debt with the danger of falling into overindebtedness. In other words, there is a real possibility for a group of elderly people that the ‘withholding credit’ might place in danger their dignity of living and they are paying the price of economic advances.

The aggressive publicity using specific fears and insecurities of the elderly, together with the use of intermediaries to persuade the elderly to take out credit, has pushed a considerable number of pension recipients to make a ‘withholding credit’. The data about the education of the elderly had shown that about a third of them are almost illiterate and another large group has serious problems with
the written language. This means that most of them have a very vague idea about the functioning of the financial market, interest rates, credits, etc., and they depend mostly on others to understand the contracts they sign. On the other hand, the research data shows that in many cases the credit is not even for the elderly themselves, but for other people, generally in their families. The low education level of the elderly, their specific situation (health problems, in-family dependants) and their disposition to help other family members, but also the low pensions of most of them, makes many elderly persons more vulnerable than other groups.

In this situation, two things might be important. On the legislative side, there should be more protective rules for the elderly. Even if the new regulations of January 2008 are pointing in the right direction, lowering the percentage of the pension which could be compromised, there is much more to be done. A good example is the proposal of the PROCON-SP.42

A second important activity might be educational measures to increase the knowledge of the elderly regarding financial matters and credit. We might propose a form of financial literacy campaign. Important partners in this work could be the PROCONs, DPDC,43 the senior groups, the universities of the elderly, municipal and state councils of the elderly and also the Ministry of Justice with the National Council for the rights of the elderly. Teaching the elderly how to deal with the financial possibilities and dangers and protecting them from any abuse of their specific condition might be a good way to include and to maintain them in the actual consumer society.

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42 In a number of meetings with involved groups and the public defenders, the PROCON-SP has elaborated a 10-point plan to reform the regulations for the ‘withholding credit’. See: <http://www.procon.sp.gov.br/noticia.asp?id=273>, accessed 4 July 2008.

43 Department of Consumer Policy and Protection of the Ministry of Justice, head of the national system of consumer protection in Brazil (Consumer protection code, Art 5).
Two Decades, Three Key Questions, and Evolving Answers in European Consumer Insolvency Law: Responsibility, Discretion, and Sacrifice

JASON KILBORN

As recently as 10 years ago, one would have been hard pressed to explain how lawmakers on the European continent were dealing with the growing problem of excessive consumer debt. Over the previous decade, economic crisis and financial deregulation, among other causes, had led hundreds of thousands of individuals into a new debt trap. A handful of states had taken a first step toward addressing the unique problems of these financially overextended souls, but substantial reforms of these measures were already under way. Legislators across most of Europe were either waiting for their newly adopted solutions to become effective or still debating what, if anything, to do. The last 10 years have seen a wealth of policy discussion, practice, and reform in the area of consumer insolvency.

This Chapter surveys the three most salient questions that have engaged policymakers in the last 20 years—and particularly the last 10—of insolvency law in Europe. This period has seen the discussion, emergence, and often multiple reforms of almost every consumer insolvency law in Europe. We can now see some convergence of policies across Europe over time. This Chapter situates the current status of policy in its historical context, with an eye toward predicting what the future holds. It will also offer suggestions for evolving policy, both in the countries that have adopted consumer insolvency laws and especially for those that have not done so... yet.

1 I intentionally leave aside the United Kingdom, which like the United States and other common law systems has offered insolvency relief to non-business individuals for decades. I focus here on the quite recent development of such relief in the civil law systems on the continent.
Part I untangles the numerous strands of argumentation that supported the adoption of distinct consumer insolvency laws across Europe. Part II traces the development of consumer insolvency relief in terms of two intertwined sets of defining characteristics: discretion versus uniformity, and preservation versus destruction of contract rights. Over the last decade, a clear trend has emerged, driven largely by practical concerns, favoring uniformity of treatment and aggressive discharge of debt. Finally, Part III concludes with a brief look at the sacrifices demanded of debtors and the reasons for a gradual softening of these demands, along with the sticky question of state financing for a system where most of the beneficiaries cannot afford to bear its administrative costs.

I. IS LEGISLATIVE INTERVENTION NECESSARY, APPROPRIATE?

Logically, the first question European legislators have faced is why they would drift away from centuries of dedication to the notion of *pacta sunt servanda* (agreements must be fulfilled) and intervene in the relationship between consumer debtors and their creditors. Freedom of contract had always been intimately tied to a corresponding duty to bear responsibility for the consequences of contractual choices. Beginning in earnest in the 1980s, European lawmakers began to face two closely related questions: why, after nearly 2,000 years of relatively stable contract doctrine, is a re-examination of the most fundamental notion of contract law appropriate now, and why should the balance of benefits and obligations in consumer contracts be disturbed at all.

A. Why Now?

The simple answer to the first question is debt—lots of it, like never before. An aggressive philosophy of free-market economic competition led European regulators to unleash consumer credit markets in the late 1970s and early 1980s, lifting restrictions on, for example, down-payment requirements and repayment terms. At about the same time, new information technology began to propel these markets forward with new techniques for evaluating, marketing, and administering a largely untapped market for consumer credit.

Adding the spark of technology and capital to the powder of a newly deregulated and hungry market created an explosion of consumer debt. By the mid-1980s, European consumers had begun to risk their future finances by taking on debt to an unprecedented degree. For example, while median income in Germany grew only 12-fold between 1950 and 1984, per capita indebtedness increased more than 800-fold during the same period.2 Total consumer debt in

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Germany more than doubled again between 1984 and 1994, from just under DM160 billion in 1984 to almost DM364 billion in 1994.³

Widespread availability of consumer credit had the desired effects for many people. Individuals were empowered to leverage future income to support current economic productivity and consumption. From a broader market perspective, this smoothed the demand curve for products and services, increasing economic efficiency, volume, and competitiveness.

Nonetheless, the democratization of credit also had inevitable negative consequences for some. Given the indeterminacy of the predictions that borrowing involves, as well as the inherent limitations and biases of human cognition,⁴ some borrowing decisions turned out in retrospect to have been poor, in some cases devastating. Some individuals faced economic collapse as a result of, among other things, misjudgments with respect to future financial conditions or the nature and terms of borrowing, unchecked desire for instant gratification, and unexpected financial interruptions (job loss chief among them, though also divorce, childbirth, and serious or extended illness). One study in Germany estimated that, in 1989, 1.2 million households—over 3 per cent of the total number of households—suffered from excessive debt.⁵ In Belgium, nearly 14 per cent of consumer credit contracts were registered in default by 1995, with arrearages totaling over €1.2 billion. In 1993, more than 300,000 individuals in Belgium had registered credit defaults of one degree or another, a figure that would rise 28 per cent to just over 385,000 by 2000—just under 5 per cent of the total adult population of Belgium.⁶ Applying a broader definition of financial distress, an EU-commissioned study reported that, in 1996, 64 per cent of Belgian households and 29 per cent of households in Luxembourg with non-mortgage loans were overindebted.⁷

Powerful voices rose up to draw attention to the plight of these casualties of financial market liberalization. These voices and their persuasive power are a great part of the reason why consumer insolvency relief came into being where and when it did. In Germany, a new Justice Minister in the mid-1980s advocated aggressive relief for indebted consumers, in part by uniting the efforts of the Justice Ministry and the Ministry for Youth, Family, Women and Health to commission a report emphasizing the growing problem of consumer overindebtedness and its ill-effects on families and health.⁸ In Sweden, concerned legislators

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³ L Rath, Überschuldung und Schuldnerberatung in Deutschland unter besonderer Berücksichtigung der neuen Insolvenzordnung (InsO) § 2.2 (1996).
⁵ D Korczak and G Pfefferkorn, Überschuldungssituation und Schuldnerberatung in der Bundesrepublik Deutschland XI. (Berlin, BMJ, 1992).
⁷ Betti et al, above n 6, at 2–3 and tbl. 1.1.
⁸ Korczak and Pfefferkorn, above n 5, at XXXVI.
fought for consumer insolvency relief despite opposition from a new justice minister, organizing their colleagues in June 1993 to demand a government bill. In both Belgium and Luxembourg, consumer counselors pressed legislators for action on behalf of growing numbers of financially overwhelmed consumers facing social isolation, health problems, family tension, and other social ills.

Even if a new problem had revealed itself, one might wonder why new intervention was necessary. Shouldn’t the famously generous European social safety nets have dealt with these problems? Had the nets become weaker or more porous in a way that necessitated new regulation? Though the specifics of these safety nets had changed somewhat during the late 1970s and 1980s—approximately the same time when the consumer debt crises began to mature—these changes were rather modest. The various social support structures in Europe were never designed to provide blanket protection for all risks, especially in an increasingly volatile labor market. The massive unemployment that gripped Europe in the late 1980s and 1990s would have strained the finances of many consumers in any event. Borrowing as a means of partial and temporary income replacement during short-term unemployment caused financial distress, but often limited in both degree and duration. Many consumers had taken on more significant debt levels, however, that seemed manageable while they were employed, but when they unexpectedly lost their jobs, they faced serious challenges from a thick layer of debt with relatively inflexible repayment timelines and serious penalties for default. Many had to borrow simply to refinance older borrowing, service charges and default fees snowballed, and already thin margins quickly disappeared. Even before the modest reforms of the 1970s and 1980s, traditional social welfare programs were not designed to assuage the casualties of the combined new risks of rampant unemployment and overwhelming consumer debt.

B. Even in Light of New Risks, Why Intervene at All?

Accepting that changed circumstances might call for aggressive renegotiation of contracts in individual cases is one thing. Accepting that broad-based legislative suspension of contract rights is the right prescription is quite another. As the next section discusses, not all European lawmakers embraced the most aggressive forms of relief right away, but many did, and more eventually would. The key to understanding why lawmakers accepted a decisive break with the past is

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a new vision of responsibility, focused not only on individual transactions and obligors, but on the responsible expectations of creditors, the responsible use of the instruments of state power, and a responsible balance of individual and collective economic interests.

Adhering to the rather rigid notion of *pacta sunt servanda* makes some sense when the incidence of contractual default is relatively limited, the public enforcement machinery can be engaged effectively to compel performance or offer substitute performance, and enforcement of obligations produces relatively few side effects outside the debtor-creditor relationship. As the rate of consumer financial distress climbed, substantial doubts arose with respect to each of these factors.

As discussed above, rising debt levels became unmanageable overindebtedness for many consumers in the 1980s and 1990s, leading to a significantly elevated rate of default. Though the legislative record reflects very little of this kind of thinking, one senses a rising feeling of legislative responsibility for the problem. Lawmakers had sought to take advantage of the competitive benefits of free consumer credit and labor markets, and now many were feeling pangs of conscience about the significant downside of that decision. While consumers certainly bore a substantial measure of responsibility for their own contractual choices, at least some—and probably many—legislators felt a sense of their own responsibility for easing the pain caused by their choice to expose their constituents to greater risks.

More importantly, though, legislators carefully reexamined the responsibility of creditors. Though legislators feared the moral hazard implicated by relieving consumers of their legitimate contractual obligations, they also began to realize that the law had facilitated or even encouraged inefficient and irresponsible extension of credit and enforcement actions by creditors. The new world of technology-driven lending depends on high volume and segmentation of borrowers by risk profile. As statistical credit scoring and aggressive advertising replaced laborious examination of individualized financial data, lenders accepted higher risks of default in many cases. They did not, of course, warn the consumer borrowers on these riskier loans about their individual higher likelihood of default. Legislators became increasingly concerned that lenders were both ignoring pertinent information about default risk and that they were hawking unsuitable debt to unsophisticated consumer customers. One of the explicit goals of the French and Belgian insolvency laws, for example, was to make lenders more responsible in their practices of extending credit to consumers.12 The authors of a draft law in Luxembourg placed particular blame on

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the manipulation of consumers by the aggressive and omnipresent advertising of credit establishments.\textsuperscript{13}

Whatever view one might take of the pre-default behavior of creditors, lawmakers in every country focused especially on creditor responsibility after default. It seemed increasingly irresponsible for the state to support creditors’ ill-founded expectations that many of these debts could be collected through official enforcement channels, not to mention irresponsible for creditors to continue unchecked use of these channels. Intervention would serve primarily to force creditors to take responsibility by facing facts and internalizing the negative and unjustified externalities of their unrestrained enforcement actions.

At the individual debtor-creditor level, the system allowed—indeed, encouraged—creditors to waste their own resources and the resources of the state by supporting a rapidly proliferating volume of collection efforts on many uncollectible debts. In Sweden, for example, state investigators observed that creditors’ ability theoretically to collect from substantial numbers of debtors was worthless on the best assessment.\textsuperscript{14} While still the exception rather than the rule, such worthless enforcement actions by creditors became so common as to occupy a troubling amount of the attention and resources of the courts and other enforcement authorities.\textsuperscript{15} Information asymmetry and indeterminacy, and in some cases creditor obstinacy, made even bilateral compromise solutions difficult. Creditors were unwilling or unable to make the necessary investment to determine whether a particular debtor was really unable to pay.

Multiplying this effect over many creditors introduced a further problem of opportunistic behavior. The individualistic nature of the enforcement system allowed creditors irresponsibly to ignore any interests other than their own, imposing avoidable losses on numerous other creditors when a multilateral, collective compromise was the most responsible solution. Each creditor could rationally but irresponsibly assume that its debt was collectible if the debtor could be cajoled into paying only that debt. The state enforcement mechanism became in many cases a tool to elevate the rights of aggressive and selfish creditors over the similar rights of others. By artificially propping up the illusion that all of these debts could be collected without modification or compromise, the enforcement system allowed creditors irresponsibly to create losses for themselves, other creditors, and the state, especially as the number of such cases increased. In Belgium, even the national representative of official debt collectors argued for intervention, as the recalcitrance of aggressive creditors all too often derailed attempts to negotiate multilateral settlements, leading to a needless accumulation of fees and expenses and a dead-weight loss of value.\textsuperscript{16}

\textsuperscript{13} Doc. parl. no 4409, at 11–12 (1997).
\textsuperscript{14} Lennander, above n 9, at 140–1.
\textsuperscript{15} See, eg, Morin, above n 12, at 126 (noting a substantial increase in consumer debt collections cases in France).
On an even broader level, the current system encouraged a myopic concentration on the specific debts at issue when more careful consideration of the world beyond those debts was called for. Far beyond the strictly economic issues involved in each collections case, debtors suffered such negative externalities as deterioration of their emotional, psychological, and physical health, impairing their personal and work lives. This imposed still further negative externalities on the economic and emotional health and well being of members of debtors’ families, especially their children. Lawmakers in Luxembourg aimed explicitly to reduce the social cost resulting from social exclusion.17 With these new laws, lawmakers in both Belgium and Luxembourg sought to deliver dignity and hope and offer perspectives for a better life to overindebted persons.18

Even if creditors could accept compromise solutions, traditional contract theory encouraged creditors understandably but irresponsibly to elevate their own interests over broader societal interests. Strict adherence to pacta sunt servanda would lead to long years of debtors’ toiling to repay their creditors, having very little incentive to achieve maximum productivity and development in the present when the reward of payment and release was far in the future. The negative externalities of creditor-focused enforcement action extended to the highest levels, considering the effects on state wealth distribution programs such as tax and welfare regimes. Debtors robbed of incentives to be maximally productive (or to reveal publicly the full extent of their productivity) would return less tax revenue to the state and might choose to languish in a state of dependence on welfare support rather than seeking through personal initiative to advance the economic welfare of themselves and their families. Indeed, in an increasingly competitive world, where national economies rested more heavily on consumer confidence, productivity, and spending, robbing significant numbers of consumers of incentives to enhance their productivity and enjoy active participation in the consumer economy could be a death sentence for global competitiveness.

European lawmakers were eager to avoid sacrificing tax receipts, welfare expenditures, and economic productivity and competitiveness on the altar of rigid observance of creditor rights. Some mechanism was necessary to force creditors to internalize these numerous negative externalities to achieve a healthier balance of rights and responsibilities. Formal legislative insolvency relief has been the mechanism of choice over the past two decades. German and Dutch reformers, for example, adopted consumer insolvency laws to offer debtors a perspective for their futures, an incentive to remain productive rather than capitulating to a lifetime of essentially involuntary servitude for their creditors.19 Likewise in Sweden,
the driving idea behind formal insolvency relief was to achieve broader benefits for society by minimizing the burdens on the welfare system and recapturing lost economic productivity and tax receipts from newly invigorated debtors.20

C. Residual Ambivalence About Intervention

Though they were among the first to adopt aggressive consumer insolvency laws, Scandinavian legislatures in particular remain to this day somewhat ill-at-ease with respect to this new approach to balancing responsibilities. Perhaps because of their first-mover status (Denmark adopted the first consumer insolvency law in continental Europe in 1984), the Scandinavian systems reflect most clearly a struggle with the very notion of offering formal insolvency relief to consumers. This struggle is reflected in a unique process of administrative screening of cases for reasonableness.21

The Swedish system offers a representative example, highlighting several factors to be considered in this judgment of reasonableness in offering relief. First, the debtor is expected to have grappled with debt problems for some substantial time—generally, three or four years—before resorting to formal legal relief. Second, the system is decidedly not designed to offer relief from debts incurred through reckless risk taking, luxury consumption, or bad acts. While it is easy and accurate to observe that criminal, unfair and speculative debt incurrence shall not be rewarded,22 lawmakers emphasized that no clear line of exclusion could be drawn. Finally, not only after, but before seeking legal relief, deserving debtors must have attempted to maximize their earnings through work, apply the value of non-essential property to their debts, and fulfill their obligations (or deal with their debt problems in some other way) on their own.23 Many petitions are rejected at this first stage. From implementation of the new Swedish law in mid-1994 through 2001, the state administrator rejected a fairly consistent average of about 40 per cent of all petitions, though the rejection rate by 2002 and 2003 had fallen to about 30 per cent.24 These reasonableness factors and a consistently high rejection rate reflect residual hesitancy and the continuing struggle with the first question as to the appropriateness of legislative intervention.

20 See Prop. 1993/94:123, §§ 4.1, 6.3; Lennander, above n 9, at 131 and n 11, 139 and n 42.
22 See Lennander, above n 9, at 146–47.
24 See SOU 2004: 81, above n 9, at 110 tbl. 6.1.
Once the decision was made to offer formal insolvency relief, the real work began. The decade between 1998 and 2008 in particular witnessed a continuing struggle to strike an appropriate balance between the sanctity of contracts and the need to make formal relief effective if it was to be offered. On the one hand, all of these systems are designed to a greater or lesser degree as adjuncts to the preferred solution of private renegotiation. On 1 January 2007, Sweden became the first and only state thus far to move away from a uniform model of private or semi-private negotiation as the entry point into any type of formal coercive relief. Beyond this initial point of similarity, the systems have differed significantly on the next key question: how to force intransigent creditors to accept a responsible approach. To put it more mildly, when a negotiated solution is not possible because of the refusal of one or more creditors to agree, how far is the state willing to abandon the underlying contracts at issue. More importantly, to what extent will the system produce individualized solutions hand-tailored to each case, rather than routing every case through the same uniform steps toward the same effective relief.

In the beginning, the various European insolvency laws arranged themselves on a continuum with respect to this bipartite question. On the one end, relief was little more than a modification of each debtor’s various obligations, and the exact form and extent of modification was left in the largely unfettered discretion of the system administrator. This description applies to the systems as initially adopted by countries that might reasonably be categorized as French or Romanistic: France primarily, but also Belgium and Luxembourg. At the other end of the continuum, every debtor received the same predictable treatment, was subject to the same predictable demands, and would receive the same uniform and aggressive relief upon successful fulfillment of the law’s demands: a discharge of all remaining debt (with some minor exceptions). This description applies to the systems adopted by countries that might reasonably be categorized as Germanic: Germany primarily, but also Austria, and to a lesser degree the Netherlands and Sweden (along with the other Scandinavian states). This continuum has been in flux over the last decade, with a clear movement toward the Germanic end, but only after a long, slow struggle at earlier points along the way between discretionary modification and uniform discharge.

A. Discretionary Modification à la française

When it was adopted on the very last day of 1989, the French system stood on the far end of the spectrum just described. Indeed, its primary quite limited

25 See Kilborn, above n 23, at 458–60.
purpose was to offer formal, structured support for private renegotiation of distressed debts, in much the same way that the various networks of credit and debt counselors had been doing for years in neighboring countries. Each département now had its own official state service offering relief to overindebted individuals, a commission de surendettement des particuliers (commission on individual overindebtedness). Unlike other credit counseling structures, however, the French surendettement system incorporated a secret weapon to maximize the willingness of creditors, especially private banks and finance companies, to accede to informal concessions. At the center of each commission, the Banque de France is the primary architect and broker of compromises, and it has been quite successful over the years in achieving informal compromise in a clear majority of cases.26

Once again, though, the difficult question facing these systems is what to do when creditors cannot be convinced to accept a responsible compromise position. For nearly the first decade of its existence, the French system remained unwilling to go beyond discretionary modification. The commissions could recommend to the local courts that the compromise workout plan that they had developed be formally imposed on creditors, but neither they nor the courts could go any further. The only sorts of relief that could be imposed were quite limited modifications of the original obligations, such as a deferral or extension of time to pay, reduction or elimination of accruing interest, or the creation or substitution of a guarantee. Courts could impose such concessions over a period of five years—increased to eight years in 1999 and then to 10 years in 2003—with full discretion to choose the proper duration.27

These measures could be conditioned on the debtor’s doing or not doing certain things, and the commissions exercised unconstrained and widely varying discretion to make quite stringent austerity demands of debtors. The economics ministry and others repeatedly expressed concerns that some commissions were exercising their discretion to recommend workout plans that required too much sacrifice by debtors and their families in order to satisfy creditor demands.28 This dedication to a discretionary model offering limited relief would create problems that would hound the French system for many years.

The systems in Belgium and Luxembourg are marked by a similar reliance on official discretion, though at least the system in Belgium has provided for aggressive relief from early on. Both begin with a debt negotiation model similar to that in France. Somewhat like the commissions in France, in Luxembourg an official service of information and counsel in matters of overindebtedness offers debt negotiating support. In Belgium, a court-appointed debt-mediator (in most

28 See Kilborn, above n 26, at 642–4.
cases, also a local debt counselor) draws up modified payment plans for proposal to creditors. Like in France, in a strong majority of cases semi-formal persuasion is sufficient to find a negotiated solution, at least temporarily. If creditors cannot be convinced to accept a semi-formal workout proposal, the courts in Belgium and Luxembourg can impose limited measures of relief similar to those available in France: deferral or delay of payments, reductions of interest rates, and possibly even discharge of certain kinds of penalties and fees.

In Luxembourg, no more aggressive relief is available. We see the first steps toward more invasive intervention in Belgium, where the courts are empowered to discharge any debt remaining after the debtor completes a three- to five-year workout plan. Though legislators clearly intended that such aggressive relief would remain an exception, the courts have imposed a discharge to some degree in nearly three-quarters of cases that have reached the judicial stage. Indeed, legislators initially resisted offering a complete discharge in any case, requiring every debtor to pay at least something during the course of a multi-year payment plan. After the Belgian constitutional court in April 2003 declared this restriction unconstitutional as a violation of equal protection (disfavoring low-income debtors), legislators formally modified the statute in December 2005 to allow for immediate and total discharge for debtors totally unable to pay down any of their debts over five years.

As in the early structure of the system in France, the courts in Belgium and Luxembourg are quite free to exercise their discretion in determining the appropriate level of sacrifice from each debtor in exchange for this relief. In Luxembourg, a judicial plan can require payments from the debtor for up to seven years, with no indication of what the average plan length should be. Judicial plans in Belgium are limited to five years in most cases, though plans that offer a discharge must extend over at least three years. As for the acceptable level of sacrifice from debtors, in both Belgium and Luxembourg the courts are constrained only by a vague exhortation that debtors and their families must be guaranteed the ability to lead a life in conformity with human dignity. Though the courts in Belgium are encouraged to leave all income defined as exempt from creditor seizure under other law, the insolvency law gives the court the discretion to deviate from general income protections by specially motivated decision. Initial surveys suggest that the Belgian courts are balancing creditor

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30 Code Judiciaire/Gerechtelijk Wetboek Art 1675/12 (Belgium); Law of 8 December 2000, Art 14 (Luxembourg).
31 See Kilborn, above n 29, at 98.
32 See ibid at 94.
33 Code Judiciaire/Gerechtelijk Wetboek Arts 1675/3, 1675/12 § 4, 1675/13 §§ 2, 5 (Belgium); Law of 8 December 2000, Arts 1, 14 (Luxembourg).
34 Code Judiciaire/Gerechtelijk Wetboek Arts 1675/12 § 4, 1675/13 § 5.
demands and debtors’ human dignity fairly well, but the Belgian law is notably infused with a reliance on court discretion to craft plans with the appropriate duration and demand to maintain human dignity. This core discretion with respect to both remedy and the requirements for that remedy marks the three French or Romanistic systems as distinct from the other systems in Europe.

B. The Germanic Approach: Uniformity, Predictability, Discharge

In Germany, in contrast, from the very beginning, every debtor has been subject to the same demands and offered the same relief. All of the other Germanic systems offer the same statutory relief to all comers who satisfy the law’s demands: discharge of all remaining unpaid debt (with some minor, nondiscretionary exceptions for certain types of debts). This immediately distinguishes the Germanic and Romanistic systems. An equally marked and perhaps more philosophically important contrast, however, is the degree to which the Germanic systems minimize or reject elements of discretion in determining the proper prerequisites for relief. The German system offers the starkest example of this, with the systems in the other Germanic systems extending modestly back along the continuum of discretion.

All of these systems (except Sweden since 1 January 2007) require debtors to proceed through a negotiation stage involving significant discretion and non-uniformity, but the discretion is exercised not by system administrators (as in the Romanistic systems), but by debtors and creditors. Even in Germany and Austria, where the in-court process theoretically (in Germany) and actually (in Austria) begins with an attempt to cram down a negotiated solution on dissenting creditors, the debtor and his or her projected nonexempt income define the parameters of the proposed relief—not the court exercising any degree of discretion.

After creditors have rejected a negotiated solution, and cram-down has failed, the German and Austrian systems have always funneled all cases into a single discretion-free, actual receipts track. Following liquidation by a court-

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35 See Kilborn, above n 29, at 98–9.
36 I use the term ‘cram down’ in what might be called the weak sense here, where a sufficient number of creditors (a majority) agrees to the plan to allow the court to cram down the plan on those who do not agree (the dissenters). In what might be called the strong version of a cram down, the court imposes a plan on all creditors regardless of whether or not some number of them agrees with the plan. The first in-court stage in Germany and Austria involves a weak cram down, relying on majority creditor assent to a proposed plan. This stage rarely produces a resolution, and most cases proceed to the second in-court stage, involving a strong cram down by the court of a non-discretionary payment plan without regard to creditor voting. The partially negotiated weak cram down in the first stage does involve some discretion, but the majority creditors and the debtor exercise this discretion—not the court. See J Kilborn, Comparative Consumer Bankruptcy 77–8, 81–2 (Durham, Carolina Academic Press, 2007); see also W Backert et al, ‘Bankruptcy in Germany: Filing Rates and the People Behind the Numbers’, this volume.
appointed interim trustee of the debtor’s nonexempt property, if any (which is present in few cases), all debtors formally assign to a trustee all of their actual (not projected) nonexempt income, determined according to a uniform national exemption schedule, over a uniform period of years. The period used to be seven years in both Germany and Austria until it was reduced to six in Germany in 2001. In Austria, if the debtor has paid the costs of the proceeding and 50 per cent of all unsecured claims, the debtor earns an early discharge—as a matter of law, with no discretion in the court to demand more. The law in both countries explicitly requires the debtor to exert him or herself to obtain and hold suitable employment during this period and cooperate with the trustee or risk losing the benefit of the discharge, but no other discretionary requirement is or can be imposed on the debtor.37

The unique Austrian system incorporates one small element of discretion, though it applies in relatively few cases as a measure of last resort. Debtors can lose their discharge by failing to pay at least the costs of the proceedings and 10 per cent of their unsecured creditors’ claims over the seven-year income-assignment period preceding discharge. In such cases, the court retains discretion in fairness either to confer a discharge immediately (if the debtor has fallen just short of the 10 per cent minimum) or to extend the payment period up to three more years. After ten years, if the debtor still has not managed to meet the 10 per cent or nearly so standard, the court again can exercise discretion to grant a discharge on fairness grounds to avoid the debtor’s being denied a discharge.38 In either event, though, this discretion differs markedly from that in the Romanistic systems, where the basic course of each case is determined through discretionary interpretation of intentionally vague standards.

While the presence of a uniform discharge places the Dutch and Swedish laws squarely in the uniform Germanic group, these laws theoretically slide back down the discretion scale by inviting system administrators to seek more flexible, creative paths to that relief in individual cases. Unlike in the Romanistic systems, however, Dutch and Swedish courts and administrators have largely rejected that invitation and voluntarily limited their own discretion.

In the Netherlands, much like in Germany, the law directs a trustee to collect and liquidate the debtor’s nonexempt assets and administer a payment plan drawing on three to five years of the debtor’s nonexempt income, applying a uniform national standard.39 Adding a discretionary element, the original Dutch law theoretically gave courts maximum freedom to design payment plans with whatever provisions seemed reasonable and fair.40 Dutch judges largely rejected this discretion early on, however. Most court-imposed plans simply set out a

38 See ibid at 79; Georg Kodek, Handbuch Privatkonkurs: Die Sonderbestimmungen für das Konkursverfahren natürlicher Personen 281–9 (Wien, Manz Verlag, 2002).
40 Faillissementswet Art 343(1) (repealed 1 January 2008); see also Kamerstukken II 1992/93, 22969, nr 3, p 59 (remarking on the broad discretion theoretically allowed to the court).
standardized amount of income to be left to the debtor over a standard three-year repayment term. Indeed, judges voluntarily reigned in their discretion to determine the amount left to debtors by adopting a 30-page guide for determining the proper amount.\textsuperscript{41} Developed by a working group of Dutch bankruptcy judges (Recofa) in late 2000, the semi-official guide for determining how to calculate the amount of income to be left to debtors is updated annually, with detailed standards for calculating the initial percentage of income to be allocated to the debtor along with allowable expense supplements. Indeed, as of January 2007, an interactive program available on the internet can perform the necessary calculations to arrive at the debtor’s allowed budget.\textsuperscript{42} Consistent with widespread judicial practice during the early years of the new law, the Recofa guide has since been adopted as the standard by nearly all Dutch courts.\textsuperscript{43}

In light of these developments, the Dutch legislature recently simplified and streamlined the process, eliminating most judicial discretion to apply varying standards to different cases. As of 1 January 2008, the reform law essentially codifies the unitary model adopted in practice given the standard character of many consumer debt adjustment cases.\textsuperscript{44} Judicial discretion to craft fair and reasonable plans has now been formally abandoned. Judges retain some discretion with respect to plan length and the amount of income to be left to debtors, but consistent with prior practice reformers expect that the vast majority of cases will continue to be subject to a standard three-year plan on income determined through application of the Recofa guidelines.\textsuperscript{45}

Developments in Sweden have followed a similar path. In its original form (adopted in 1994), the Swedish system stood at the middle of the discretion spectrum. Though full discharge relief has always been available at the end of a debt payment plan, the path to that relief was structured very much like in France. Each case began with a negotiation led by an official state administrator (the debt collector, Kronofogdemyndigheten, or KFM). If any creditor rejected the KFM’s proposal, the case moved to the courts for, in almost every case, imposition of the KFM’s proposed plan, very much like in France (though the formality of court intervention was recently eliminated in Sweden).\textsuperscript{46} In both Sweden and France, legislators’ original idea had been to allow the system administrator flexibility to be creative in crafting plans in individual cases tailored to individual circumstances. The Swedish statutory protection for exempt income was to be considered only guiding in the determination of how much of the debtor’s income to allocate to creditors. As for plan length, the original rule in Sweden


\textsuperscript{43} Werkgroep rekenmethode vtlb recofa, Vtlb-rapport: Berekening van het vrij te laten bedrag bij toepassing van de wet schuldsanering natuurlijke personen § 1.1 (2007).

\textsuperscript{44} Kamerstukken II, 2004/05, 29 942, nr 3, pp 6–7.

\textsuperscript{45} See ibid at 38 (discussing new Art 349a); Faillissementswet, Arts 295(3), 349a (2008).

\textsuperscript{46} See Kilborn, above n 23, at 455, 460.
was that plans should run for five years, though the KFM had discretion to establish a shorter or even longer plan if special circumstances warranted.\textsuperscript{47}

Given the narrow constraints of a uniform type of relief (discharge), small incomes, large debts, and human nature, however, Swedish practice in developing workout plans was quickly standardized.\textsuperscript{48} The KFM declined to be simply guided by the statutory income exemption and to deviate from a standard five-year repayment period. In practice, the KFM has in most cases simply adopted the general exemption level as the de facto rule, adding allowances for reasonable housing costs and certain other extraordinary expenses based on internal guidelines from the Tax Service (which controls the KFM). In addition, some KFM offices have included in debtors’ budgets a small buffer of as much as $50 per month for unanticipated expenses, though the Tax Service has expressed a particular desire to see a unified policy on the size and frequency of such buffers, as well.\textsuperscript{49} Thus, rather than engineering creative solutions, the Swedish KFM simply plugs largely standardized numbers into a simple formula to arrive at 60 monthly payments to creditors equal to the debtor’s projected disposable income over that period.

C. Movement Toward More Uniformity, More Discharge

Thus, at the mid-point of the continuum from unbridled discretion to strict uniformity, Swedish and Dutch practice migrated toward greater uniformity early on. Discretion is time-consuming and expensive, and experience showed that the benefits of greater flexibility were very small in light of the narrow room to maneuver within debtors’ limited resources and large debts. When the relief was preordained, the path to that relief could be standardized with very little danger of moral hazard. Debtors’ dedication to fulfilling their financial obligations—both before and after formal relief—would not be substantially undermined by greater clarity in the prerequisites for relief if those prerequisites were sufficiently demanding. The greater risk was imposing unrealistic demands on debtors that would produce systematic failure and administrative overload. These low-return, high-complexity cases fit well within a single paradigm: establish a reasonable level of sacrifice, hold the debtor to that level for a reasonable period of time, and little more can be realistically expected.

Indeed, though discretion and flexibility were supposed to facilitate the most attractive compromise proposals for creditors, the Dutch experience suggests that creditors might well have little preference for greater flexibility themselves. Given the choice between a maximally flexible, out-of-court negotiation process and a carefully monitored, in-court coercive process with standard demands,

\textsuperscript{47} SOU 2004:81, above n 9, at 127.
\textsuperscript{48} Ibid at 65, 111, 119, 123–24, app 3 at 299–305 (illustrating sample payment plan).
\textsuperscript{49} See Kilborn, above n 23, at 450–53; Skatteverket, Så uppfattar gäldenärer och borgenärer skuldsaneringsprocessen, Rapport 2004: 14, at 9.
Dutch creditors have seemed increasingly eager to choose the latter. Creditors accepted out-of-court negotiated workout plans less and less after the December 1998 entry into force of the Dutch consumer insolvency law. The rate of creditor acceptance of negotiated plans fell from about 35 per cent in 1998 to 28 per cent in 1999 before plummeting to between 10 per cent and 15 per cent per year after 2003. Credit counselors reported that creditors were generally less willing to enter into voluntary arrangements in light of the standardized and predictable court-imposed alternative.

A similar administrative and then legislative movement toward standardization is observable in France. In their zeal to achieve the maximum possible reduction of debt problems, some French commissions and courts relegated debtors to lives of extreme austerity, while others heeded government suggestions to use the statutory income exemption level as an informal baseline. The French system remained mired in the discretionary modification model until the first major reform was implemented in 1999.

After nearly a decade of trial and error, the legislature responded from above by moving the French system mildly toward the Germanic uniformity end of the discretion continuum. As of 1 February 1999, the commissions and courts lost their discretion to leave debtors less than the statutory income exemption. This brought the French system largely into line with the Germanic systems with a similar uniform baseline of income protection, though the French law maintains a heavy Romanistic dose of discretion. It describes exempt income only as one part of the resources necessary for ongoing expenses. The French process remains more discretionary than any of the Germanic systems, as the law encourages deviation from exempt income (unlike in Germany) with no clear guidance on how that deviation should be made (unlike the guidelines of the Dutch Recofa or the Swedish Tax Service). The future may well see further harmonization efforts in France, as the Banque de France is reportedly considering making greater efforts to unify practice among the commissions in allocating income among debtors and creditors. In any event, discretion in the choice of relief remains a distinguishing factor in France.

The greatest changes in France have occurred with respect to the range of choice for available relief, expanding it far beyond simple modification. Early

50 See Kilborn, above n 41, at 95.
52 Code de la consommation Art L.331-2 (2004). This was not an uncontroversial point, as the Senate feared exposing low-income debtors to the moral hazard of shielding all or most of their income in exchange for a discharge. See, eg, Sénat, Avis, Doc. No 473 (1998); Sénat, Rep. No 544 (1998).
53 Code de la consommation Art L.331-2 (2007) [emphasis added].
54 See above, text accompanying nn 42–4, 48–50.
limits on the types of relief the French commissions could recommend for court imposition virtually ensured that the system would fail to offer meaningful relief in many cases. Given the modest financial resources and large debts involved, deferrals and extensions were simply inadequate to allow many debtors to satisfy all of their obligations. One 1995 national study suggested that 28 per cent of debtors could barely cover reasonable living expenses, let alone pay anything on their debts, and only 25 per cent of debtors clearly had the capacity to repay any significant portion of their debts after covering reasonable living expenses.56

A revolving-door trend soon developed, in which the commissions and courts would hammer out a payment plan imposing a multi-year deferral of all payments, with full expectation that the debtor would be back with a repeat filing for relief upon the expiration of the deferral period. Indeed, a 2001 survey by the Banque de France57 revealed a level of financial distress for which even a reformed version of the system was patently unable to offer meaningful solutions. Legislators noted with concern that, although at least a quarter of debtors seeking relief were clearly unable to pay any of their debts and were not likely to be able to do so in the foreseeable future, only a small fraction ultimately received effective relief in the form of a voluntary remission or court-imposed discharge. For these debtors, passage through a system that offered anything less than full (and in some cases immediate) discharge represented little more than a pure formality, and their complex cases placed a grossly disproportionate administrative burden on the commissions.58

The French legislature in two stages has made available much more aggressive relief in recent years. First, since 1999, the commissions can recommend—and the courts can impose—extraordinary measures of relief, going beyond simple modification of existing obligations. After a general moratorium on debt servicing payments on all of the debtor’s debts for up to two years,59 if an ordinary payment plan is still inadequate to put the debtor back on the path to satisfaction of his or her debts, the court can grant a partial, pro-rata discharge of the debtor’s remaining unpaid debts (again, with minor exceptions for non-dischargeable debts, such as child support obligations and criminal fines).60 Indeed, an expansive interpretation of the law by the Cour de cassation in 2001 offered the possibility of combining ordinary payment modifications with the extraordinary moratorium and discharge, further broadening the palate of relief options available.61 Second, since early 2004, the legislature has offered some debtors an immediate and full

56 See Hyest and Loridant, above n 12, § I.B.1(a).
59 This period was three years before 2003. See Code de la consommation Art L.331-7-1 (1999).
60 Code de la consommation Art L.331-7-1 (2007).
discharge, by-passing the payment plan/moratorium stage altogether.\footnote{Code de la consommation Arts L.332-5 to 332-12 (2007).} This is even more aggressive relief than that offered by the Germanic systems.

Even as French lawmakers have accepted more intrusive relief, however, they have held fast to a model of relief dispensed as a function of largely unpredictable administrative choice rather than statutory prescription. Both admission to and application of these paths to more effective relief still rely heavily on discretion. Only debtors whom the \textit{commissions} identify as falling within a loose definition of insolvent are routed to the extraordinary moratorium form of relief, and the law leaves to the case-by-case discretion of the \textit{commissions} and courts exactly what percentage, if any, of the debtor’s obligations to discharge. The \textit{commissions} and courts stand as discretionary gatekeepers to the immediate discharge track, as well, admitting only debtors whose financial situation they deem irremediably compromised according to yet another loose definition in the law (the manifest impossibility to remediate the debtor’s financial troubles with ordinary or extraordinary measures of relief).\footnote{Ibid, Arts L.330–1, 331–3.} Indeed, even for the most overextended and financially troubled debtors, the courts retain the discretion to add requirements for the ultimate relief. In immediate discharge cases, the court may, but need not, order the debtor to undertake measures of social follow-up, the existence and nature of such measures being vested in the totally unrestricted discretion of each judge.\footnote{Ibid, Art L.332–9.}

Fortunately for debtors, the \textit{commissions} and courts have chosen in recent years to exercise their expansive discretion liberally in favor of debtors. They have adopted an arguably overbroad interpretation of the key password of insolvent,\footnote{See Kilborn, above n 26, 652–3.} and they have found an increasing portion of debtors irremediably compromised and routed them to immediate and full discharge.\footnote{See Kilborn, above n 36, at 69 (noting that nearly half of all recent cases not disposed of at the agreement stage have been routed to an immediate discharge).} As the number of debtors routed to a discharge increases, the next step in France seems likely to be a simplification of the system to offer effective relief to all on more predictable terms.

III. MEASURING THE APPROPRIATE SACRIFICE: WHAT COST TO DEBTORS . . . AND TO THE STATE?

The final crucial question in every case has been how to balance the \textit{quo} of formal relief against the \textit{quid} of an investment of serious effort and sacrifice by debtor-beneficiaries. On the one hand, this is a philosophical issue that relates back to the first question: if intervention is appropriate, must it not be reserved for those who both deserve and are willing to earn it? On the other hand, it is a
very practical question of system effectiveness: human nature being what it is, particularly in light of economic forces beyond the control of most national legislators, what level of investment/sacrifice can debtors reasonably bear to prove their worthiness? Indeed, in an environment where many debtors are unable even to meet basic needs, how should the state finance the operation of the relief system, and is state investment in a long-term, discretionary administrative process worthwhile when the return from most debtors is negligible? In a few places in particular, lawmakers have struggled with and implemented creative solutions to these final questions.

A. Debtors: Demanding Rhetoric Cedes to Harsh Reality

As noted above, most systems either immediately or eventually settled on the statutory income exemption as the threshold for debtor sacrifice. Presumably, these exemptions had been established through careful analysis of the minimum financial support required for modest but sustainable existence. Legislators in France quickly learned that reducing debtors to a subsistence life below this boundary led to almost certain failure, producing much more system-wide harm than good.

When the German insolvency law went into effect in 1999, debt counselors and other debtor advocates complained about the very modest income exemptions to which debtors were to be subjected for years on end. The German parliament responded in 2002 by increasing the income exemption levels for the vast majority of German households by 50 per cent, in addition to instituting bi-annual indexing. As a result, about 80 per cent of debtors were no longer required to cede any of their meager income to creditors. These kinds of moves demonstrate that the primary concern in Europe over the past decade has been to ensure successful rehabilitation of debtors—not necessarily to squeeze the last drop of juice from the rind for creditors.

Not only in Germany and France, but throughout Europe, the trend has been toward demanding less investment from debtors, rather than more, and offering supports and incentives to enhance system success. Dutch practice, in particular, illustrates the types of efforts undertaken to ensure that a rigid uniform standard does not undermine effective delivery of relief.

As discussed above, in both the Netherlands and Sweden (and now also in France), exempt income is only the starting point for ensuring debtors a livable existence and offering the necessary incentives to remain productive. From the very beginning, Dutch judges realized that success would be hard to come by if all debtors were relegated to years of life on the statutorily prescribed 90 per cent of the existence minimum. Most immediately increased the allowance, particularly for debtors with income from at least 18 hours of work per week. For especially

67 See Kilborn, above n 19, at 285–6.
vulnerable working singles, judges offered a substantial increase (as much as 40 per cent) in the amount left to the debtor as an incentive to earn more than the standard minimum income level. Dutch judges softened the demands for debtor sacrifice in response to an acknowledged need for debtors to have some reserve for large or unexpected expenditures, in addition to encouraging debtors to find and hold work.68 In many cases, the Swedish KFM has responded to similar concerns in a similar way, adding allowances for housing and other major expenses, and modestly increasing debtors’ monthly allowances with a buffer of some small standard amount. Similarly, the German law contains a unique institution of so-called motivation rebates, urging debtors forward through the final lean years of the process with year-end bonuses of 10 per cent and 15 per cent of their non-exempt income.69

Moreover, in Sweden and Germany, legislators have reduced the duration of the required investment from debtors. As of January 2002, the uniform good behavior period in Germany was reduced from seven to six years, and a new method for measuring the beginning point of that period avoids previous delays of as many as four more years in some cases. After Swedish legislators noticed that system administrators had largely abstained from imposing plans longer than five years, as of 1 January 2007 they strictly limited the conditions under which plans exceeding five years can be imposed.

In some cases, the reduction of the payment term occurred before enactment of the law. For example, the original bill that ultimately became the Belgian insolvency law proposed a seven-year payment term in all cases. Even this long period was defended in terms of avoiding discouragement for the debtor while maximizing chances for more debtors to pay their debts in full. Proposals for reducing the term to four years immediately followed, with the legislature finally adopting a five-year compromise.70 Similarly in the Netherlands, the government’s initial bill proposed vesting the court with full discretion to determine payment terms of up to five years. Legislators preferred a three-year presumptive period, with discretion in extraordinary cases to impose five-year plans, as longer plans led to flagging motivation by consumer debtors and markedly increased levels of repeat debt problems.71 Expecting debtors to spend longer than three years on minimal exempt income while paying off their debts, legislators suggested, would be from a social point of view not responsible.72 Judicial practice has seen very few deviations from the low end of this range—the vast majority of Dutch plans imposed by courts extend over three years.73

The latest Dutch reform seeks even further to limit the time during which debtors are subjected to formalistic payment plans that offer little payment to

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68 Werkgroep rekenmethode vtlb recofa, above n 43, §§ 4.2, 5.1–5.2.
72 Kamerstukken II 1994/95, 22 969, nr. 19, p 5; see also Handelingen II 1994/95, 99, p 6071.
73 See Kilborn, above n 41, at 102.
creditors. As of 1 January 2008, cases can be terminated with a discharge after only one year—avoiding the burden on the debtor as well as the waste of administrative resources in the second and third years—if the trustee has no expectation that the debtor can satisfy his obligations in such a way that the continuation of the proceedings is justified.74 This justified criterion is broader, and reformers hope it will be applied more frequently, than the previous provision, which allowed early discharge only for debtors unable to satisfy any of their debts, even in part. The legislative history suggests that an expected distribution of less than 2 per cent of unsecured creditors’ claims would trigger this new provision.75 Freeing debtors from payment plans early because they would not offer significant payments to creditors is an innovation that suggests a fundamental reevaluation of the responsibility-inculcating role of the process. Given the expense that these insolvency systems involve, this innovation may well spread to other areas soon.

B. Redirecting Administrative Costs to Debtors and Creditors to Reduce State Expense

In the final analysis, these systems have to be paid for. To reduce the administrative and cost burden on the judicial system, French and Swedish legislators in 1995 and 2007, respectively, removed the courts from the process as much as possible. Administrators had done a fine job of weeding out undeserving cases and establishing reasonable compromises with creditors, so court involvement had proven to be little more than an exercise in outmoded formalism. Courts would provide backup to these now almost wholly administrative systems, but further expenditures of time and resources by the courts had proven to be inefficient and unnecessary.

In places where the courts have remained in a central role, lawmakers have struggled with controlling costs. In Germany, the original insolvency law mandated dismissal of insolvency petitions filed by debtors whose available assets obviously would not produce sufficient proceeds to cover substantial court costs. Most courts refused to extend litigation cost assistance to support consumer insolvency cases. Thus, nearly 90 per cent of all consumer insolvency cases were doomed at the outset, ironically, because these debtors had so few assets that they could pay neither their debts nor even court costs.76 A 2001 reform law adopted a deferral solution—debtors could put off paying court costs until after they had gone through the insolvency process.77 In the

75 See Kamerstukken II 2004/05, 29 942, nr. 3, pp 5–6, 36–37.
76 See Kilborn, above n 19, at 279 and n 130.
77 Insolvenzordnung §§4a–4d, 26(1), 298 (2007). The effects of this change of bankruptcy filing rates are detailed in Wolfram Backert et al, above note 36.
meantime, the federal states (Länder) bore the substantial budgetary burden of financing a rather expensive process of official notices and hearings in 80 per cent of consumer cases.

In August 2007, after years of study and consideration of a series of controversial proposals, the German government finally introduced a reform bill, which the Bundesrat approved in October 2007.\(^7\) If the Bundestag passes the bill, as widely expected, debtors with insufficient projected nonexempt income to cover court costs will be required to make monthly contributions toward defraying the minimum costs of the interim and permanent trustees (approximately €20 to €25 per month for the 72-month good behavior period). Debtors unable to make this sacrifice from their exempt income will be denied access to relief. This represents a serious shift in the responsibility burden from the state back onto debtors, and it brings the German system almost full circle back to where it began in 1999, when most consumer cases were immediately dismissed for asset insufficiency to cover administrative expenses. Perhaps those unable to spare even €25 per month are so judgment-proof as to not need insolvency relief, but this debate will doubtless continue into the next decade.

Belgium has developed the most brilliantly creative solution to the task of assigning duties, encouraging responsibility, and containing state costs. In contrast to their German counterparts, Belgian legislators were most concerned about hampering access to relief for low-income debtors unable to pay the debt-mediated’s administrative fees in full (precisely the same group that is the focus of the recent German reform movement).

The creative Belgian solution to financing a fund to defray these administrative costs returns to the first question of responsibility. Legislators reasoned that these costs could be most fairly and effectively spread by assigning them to creditors, in particular to creditors who bore the most responsibility for the predicament faced by these poorest of debtors. The supply side of the consumer credit market had benefited handsomely at the expense of consumers, and their credit-score-based, large-portfolio lending practices were responsible for much of the pain of the new consumer insolvency crisis. It is normal, one legislator opined, that the costs tied to the treatment of overindebtedness should be, in part at least, incorporated into the cost of credit.\(^7\) Part of the driving idea was to force creditors to internalize the costs of their overly aggressive risk-taking and to encourage more responsible analysis of the future solvency of potential consumer borrowers. Thus, to focus the negative incentive on excessively risky lending, a fractional percentage tax is assessed only on that portion of the total consumer lending portfolio in default as of the end of each year. The receipts from this tax are placed in a fund used to pay the administrative costs of insolvent debtors.\(^8\)

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\(^7\) Bundesrats Drucksache 600/07 (12 October 2007).
As problems with financing the relief system become more acute in places like Germany, solutions like this one offer broad advantages that tie in nicely with the responsibility concerns that gave rise to these systems in the beginning.

CONCLUSION

What a difference a decade makes! A new, broader vision of responsibility has swept across European consumer credit markets. The time-honored slogan of honoring contracts at virtually all costs has yielded to a healthier balance of individual and collective interests in the enforcement process. Rhetorical demands of maximum sacrifice by debtors and minimal interference with contracts have eroded as the realities of human nature, incentives, and economics have shown that only more fundamental relief and more modest demands would produce the desired rehabilitation. At the detail level, individual tailoring of solutions has largely given way to mass production of standard debt adjustment routines. European policymakers seem to be gradually converging on a unitary paradigm of consumer insolvency treatment. Still, many countries in Europe have yet to enact any public system for relief of consumer overindebtedness. As they begin to do so, and as existing systems continue to evolve along the lines described here, the next decade promises to be even more interesting than the last.
A Law-in-Action Approach to Comparative Study of Repayment Forms of Consumer Bankruptcy

JEAN BRAUCHER*

I. INTRODUCTION

THE PRIMARY OBJECTIVE of this Chapter is to propose criteria for empirical evaluation of the success of different countries’ repayment (or debt adjustment) forms of consumer bankruptcy (or insolvency). The Chapter also gathers examples of available (or unavailable) data from several parts of the world (North America, Australia, and Europe), both to begin the process of comparison and to point out how little data we have and thus how much we have yet to learn about how well the various systems work.

My premise is that there is now sufficient convergence in consumer bankruptcy and insolvency approaches around the world that some key common criteria can be used to compare them. This premise needs some justification, given the body of literature suggesting that there are different models in use in various countries, with different objectives. In the relatively young field of comparative consumer bankruptcy and overindebtedness, there is more theoretical than empirical literature. Theoretical studies have identified different models (liberal, or individualistic, as opposed to communitarian; market-driven versus morality-inspired) and perspectives (structural versus cultural). Scholars also

* Thanks for helpful comments to participants in the Law and Society Association consumer debt group in Berlin in July 2007 and participants at a University of Iowa School of Law workshop, especially Katherine Porter.


have noted a trend toward convergence of approaches in bankruptcy systems.\textsuperscript{3} Perhaps more importantly, countries around the world are all experiencing growth in consumer overindebtedness, a phenomenon driven by the expanding global consumer credit market, which in turn seems to lead to similar policy responses.

Convergence of bankruptcy approaches has accelerated. While the United States has begun ‘means testing’ the fresh start\textsuperscript{4} and in the process has reduced access to bankruptcy, resulting (at least temporarily) in proportionately more use of Chapter 13 repayment plans,\textsuperscript{5} some European countries have recognized that a discharge must be more readily available to the worst off.\textsuperscript{6} In the last two decades, Canada and Australia have added surplus-income contribution requirements to their ‘straight’ bankruptcy options,\textsuperscript{7} while also adding repayment agreements as alternatives.\textsuperscript{8} The United Kingdom has recently added a ‘debt relief order’ form of personal insolvency and has also instituted ‘debt repayment plans’ for those debtors ‘who are willing and able to pay off their debts over time.’\textsuperscript{9}

No system in action, as opposed to in theory, is straightforward or based on a single model; indeed, no system probably ever has been that way. For example, repayment and limitations on discharge have long been part of Chapter 7 in the US, the supposed fresh start chapter. In other countries, debt adjustment options continue to fascinate, despite empirical glimmers that success is elusive and seemingly endless adjustments toward more realism about repayment of old debt.\textsuperscript{10} The romance with repayment forms of bankruptcy depends on focusing

\textsuperscript{3} See J Niemi-Kiesiläinen and AS Henrikson, \textit{Legal Solutions to Debt Problems in Credit Societies—A Report to the Council of Europe} 43 (Sweden, Umea University, 2006) (noting movement in some European countries toward full discharge and less repayment); and JJ Kilborn, ‘Two Decades, Three Key Questions, and Evolving Answers in European Consumer Insolvency Law: Responsibility, Discretion, and Sacrifice’ at 9, 11–15, available at <http://ssrn.com/abstract=1080252> (17 December 2007) (concerning easier access to discharge, particularly in Belgium, the Netherlands, Austria, Sweden and France).


\textsuperscript{5} Below n 31.

\textsuperscript{6} Above n 3.


\textsuperscript{8} J Duns and R Mason, ‘Debt Agreements Down Under,’ see Chapter 17, this volume.


\textsuperscript{10} Above n 3.
tenaciously on the ideology and hopes behind them, while avoiding examination of actual results.11

Another aspect of international convergence is increasing complexity of systems. No system has been simplified in recent years. Instead, we see new options and attempts to tweak systems by adding features, particularly in response to credit industry lobbying. The question that system designers have not faced is whether policy or ideological objectives are feasible. A more empirical view of systems, based on more and better data collection, could help to correct over-optimism among policymakers.

Complexity increases costs and thus decreases access to debt relief, leaving debtors subject to collection efforts for longer. Complexity also prevents consumer debtors from understanding their options, increasing the likelihood that professionals will interfere with rational sorting either out of self-interest or lack of understanding about the achievable.

Parts II–IV discuss three criteria for evaluation of repayment forms of proceedings: creditor repayment net of administrative costs, rates of discharge, and treatment (particularly as judged by whether debtors have debt problems again). Part V discusses rational sorting among options as a means to reconcile goals. These sections also give examples from available governmental and academic data to begin the process of comparing the systems in North America, Australia and Europe, while acknowledging the current limited knowledge. Looking at data generation in different nations, one finds governments playing a bigger role in some instances, while in others, academics are more important. In Australia, for example, government data dominate, while in the US, academic researchers have been the primary source of information, although this may be about to change as a result of new reporting requirements under the 2005 US law.12 It is also often revealing to see what data are not gathered.

The three criteria or goals are sometimes in tension with each other and sometimes mutually supportive. The first two, creditor repayment and debtor discharge, are in tension. When the third, treatment, means learning by repaying as much as possible, this goal is consistent with trying to maximize creditor repayment but in tension with providing debt relief through discharge. If treatment also focuses on getting debtors on a sustainable financial footing, it will be enhanced by rational sorting of those who can and cannot repay old debt. Rational sorting is a way to attempt to get the most of each goal with the least sacrifice of others.

II. CREDITOR REPAYMENT NET OF ADMINISTRATIVE COSTS

A goal of all systems is creditor repayment to the extent possible, consistent with other goals, particularly debt relief. Thus, we need information about distributions to creditors to evaluate and compare systems. Information is useful in myriad forms, including total distributions, distributions per participating debtor, and average and median percentage amounts paid to creditors on their claims. Also, it is important to know the percentages of all distributions made to secured as opposed to unsecured creditors. Since secured creditors are protected by recourse against collateral, distributions to them in insolvency proceedings provide less justification for a system than payments to unsecured creditors. On the other hand, even with unsecured debt, some portion might be paid without an insolvency proceeding. To evaluate repayment plan options, the important question (and a very hard one to track) is how much more is paid than might be paid otherwise, either in straight bankruptcy or outside bankruptcy. Also, where a system has multiple options, it is important to know how much repayment occurs in each one. Some repayment is often a part of options that are not primarily defined as involving repayment. Conversely, little repayment may occur in supposed repayment options due to lack of approval of repayment proposals or plans, default on plans and low percentage plans.

Costs of achieving distributions to creditors also should be tallied. Costs come in multiple forms. Debtors often pay fees of various kinds, such as filing fees or fees to professionals (for example, lawyers, accountants or counselors). Government and nonprofit agencies have costs, which may be paid by taxpayers in part; these costs are sometimes recovered in whole or part from filing fees or fees assessed against contributions of debtors from liquidation of assets or payments from income. Yet another cost, not easily measured, is how much creditors spend to participate in any system, whether in attempts to work out plans informally or in costs of filing and pursuing claims in formal proceedings.


13 Debtors pay substantial filing fees in the US but none in Australia. See below, nn 24, 43–4 and 52. In the US and Canada, professional fees are substantial (for accountants who serve as trustees in Canada and for debtors’ lawyers in the US). Private professionals are not necessary in Australia (although they are used for debt agreements) or Europe.

14 Australia and Europe subsidize their systems and do not recover as much of their costs from fees as in Canada and the US. See below, n 43 (concerning services provided for free to Australian debtors) and above, n 3, Niemi-Kiesiläinen and Henrikson at 56–7 (describing desire in European countries to keep cost to debtors low by providing free services). See also US Government Accountability Office, Bankruptcy Reform: Dollar Costs Associated with the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 [hereinafter, GAO Dollar Costs Report], June 2008, available at <http://www.gao.gov/new.items/d08697.pdf> at 18–21 (noting costs of US Trustee System and federal judiciary not recovered from bankruptcy fees in recent years).

15 Trustees’ fees, for example, are often taken from distributions.
Even without creditor and taxpayer outlays, a useful index of a system’s efficiency is total administrative cost paid by debtors, directly or indirectly (including filing fees, professional fees, and percentage fees for administration taken from distributions that otherwise would go to creditors) as a percentage of distributions to unsecured creditors.\(^{16}\)

The United States provides an interesting example concerning creditor repayment, in excess of administrative costs, made by debtors who file in Chapter 13, which typically involves a debtor proposing a three-to-five-year plan. Academic researchers have studied how much is paid in that option relative to administrative costs. The leading study, by Scott F Norberg and Andrew J Velkey, in part used government data and found that partial Chapter 13 costs (those reflected in trustee records) equaled 59 to 78 percent (66 percent average) of disbursements to general unsecured creditors between 1994 and 2003.\(^{17}\) The costs counted in trustee records included debtors’ attorneys’ fees paid in the plan and percentage trustee fees, but the figures seriously understated total costs by not including upfront debtors’ attorneys fees and filing fees, creditors’ attorneys’ fees and other costs, or the cost of bankruptcy court and clerk operations not covered by filing fees and absorbed by the federal government.\(^{18}\) In other words, administrative costs may well exceed disbursements to unsecured creditors. The ratio of costs to unsecured debt repayment can be expected to rise as more of the cases in the system are ones filed under the more complex 2005 Act, which has increased administrative costs.\(^{19}\) Filing fees in Chapter 13 were $274 as of mid-2008\(^ {20}\) and attorneys fees of $3,000 to $4,000 were common, with part of that often paid up front rather than in the plan.\(^ {21}\)

Chapter 13 is marked by high percentages of disbursements going to repay secured creditors. In the years 1994 to 2003, 60 to 69 percent of Chapter 13 trustee disbursements went to secured creditors.\(^ {22}\) These figures seriously understate payment to secured creditors because they exclude debtors’ direct payments of ongoing mortgages, not through the trustee, a practice that is permitted in some districts but that has declined in recent years as more Chapter 13


\(^{17}\) Above n 16 at 533 fn 164 and 535. For the Chapter 13 Standing Trustee Fiscal Year 2006 audited annual reports, see <http://www.usdoj.gov/ust/eo/private_trustee/library/chapter13/docs/ch13ar06-AARpt.xls>.

\(^{18}\) Above n 16 at 533 fn 164 and 535.

\(^{19}\) See J Braucher, ‘The Challenge to the Bench and Bar Presented by the 2005 Bankruptcy Act: Resistance Need Not Be Futile,’ 2007 University of Illinois Law Review 93, 122–42 (concerning increased burdens on attorneys with resulting upward pressure on attorneys’ fees).


\(^{21}\) <http://thebklawyer.com/thebkblog/?s=attorneys+fees> (discussing practice in Northern District of Georgia of routine approval of Chapter 13 fees of $4,500 to $5,000 for confirmed cases and $3,500 for cases dismissed before confirmation, with $600 paid up front). See also above n 14, GAO Dollar Costs Report at 25–6 (noting $3,000 as median attorney fee in February 2008 for ‘no look’ fees approved by bankruptcy courts without question).

\(^{22}\) Above n 16 at 534.
trustees require payment of the mortgage through them. In the years 1994–2003, as a percentage of total disbursements, trustee disbursements to general unsecured creditors ranged from 21 to 30 percent and to priority unsecured creditors from 7 to 14 percent.

Higher expectations for unsecured debt repayment have developed in some areas of the US as a matter of local legal culture created by judges and Chapter 13 trustees, with proposed plan payments clustered at the high and low end. There is also considerable district variation in proposed plan length, with a median of 60 months (the longest amount permitted by law, even though 36 months was the typical legal requirement). Plan completion is more likely with a shorter plan. As will be discussed in Part III on rates of discharge, the overall completion rate in Chapter 13 in the Norberg and Velkey study was only 33 percent, and this means that less is paid than is proposed. Low percentage plans and high failure rates seem likely to continue under the 2005 law as a result of higher administrative costs and pressures to pay more to secured creditors. Overall, use of bankruptcy went down under the 2005 law, even more for Chapter 7 than for Chapter 13.

Chapter 7, nominally a ‘liquidation’ of assets, does not in fact often involve liquidation because most debtors own nothing in excess of exemption amounts. Although Chapter 7 does not have a surplus income requirement per se, many debtors do repay some old debts out of income, either through formal reaffirmation or by informal means, yet there is no available information on how much old debt is thus repaid. US bankruptcy law also has a very long list

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24 Above n 16 at 535.
26 Above n 16 at 477.
27 Ibid at 528 (with highest rate of 60-month plans, 85 percent of cases, in the Western District of Tennessee as a result of culture there pushing for them).
28 Ibid at 527.
29 Ibid at 518.
31 In 2004, the last full calendar year before the amendments, a total of 1,562,621 nonbusiness cases were filed in Chapters 7, 11, and 13, with 444,352 (28.4%) in Chapter 13. These figures dropped in 2007 to 822,590 and 321,359 (39%) in Chapter 13, rising in 2008 to 1,074,225 and 358,947 (33%) in Chapter 13. See <www.abiworld.org>, ‘Quarterly Non-business Filings by Chapter (1994–2008)’.
32 About 95 percent of Chapter 7 cases are ‘no asset,’ and most of the 5 percent with assets are business liquidations. See Report of the National Bankruptcy Review Commission, Bankruptcy: The Next Twenty Years at 137 (20 October 1997) and E Flynn et al, ‘Bankruptcy by the Numbers’ (December 2002) available at <http://www.usdoj.gov/ust/eo/public_affairs/articles/docs/abi122002.htm> (reporting that for Chapter 7 cases closed in the year ending June 30, 2002, 96 percent involved no liquidation).
of nondischargeable debts$^{34}$, debtors often emerge from Chapter 7 still legally obligated for some old debts.$^{35}$ Again, we do not know how much of that debt gets repaid. We do know that the administrative costs of Chapter 7, even in no asset cases, typically total $1,300 or more,$^{36}$ in exchange for an often partial discharge.

Australia and Canada both require surplus income contributions in bankruptcy while also providing repayment plan options. In both countries it seems to be an obvious question what the comparative returns to creditors are in the different options.

Australia has two main forms of individual insolvency. In a bankruptcy, debtors above a fairly low income threshold are liable for a surplus income contribution of half the amount above the threshold for 12 months.$^{37}$ The other main option, added by bankruptcy amendments in 1996,$^{38}$ is a debt agreement (DA), which requires a proposal by the debtor and assent by a majority (in value) of creditors.$^{39}$ According to government figures, in 2006–07, 23,732 debtors filed for bankruptcy$^{40}$ and 3,616 (about 15 percent) of those were liable for a surplus

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$^{34}$ 11 USC § 523(a). Common categories of nondischargeable debt include recent income and property taxes, child support, student loans, and credit cards debts for recent cash advances or purchases of ‘luxury goods or services,’ defined as amounts not ‘reasonably necessary’ for support of the debtor and dependents. 11 USC § 523(a)(1)(A), (a)(5), (a)(8), and (a)(2)(C).

$^{35}$ See ER Wedoff, ‘Major Consumer Bankruptcy Effects of BAPCPA’ (2007) University of Illinois Law Review 31, 42 (concerning expansion of nondischargeability for presumed fraud in acquisition of ‘luxury goods’ and in taking cash advances and expansion of student loan nondischargeability to include commercial educational loans that are not government insured).

$^{36}$ The filing fee in Chapter 7 since April 2006 is $299. See <http://www.uscourts.gov/bankruptcycourts/fees.html> (listing filing fees for each chapter). Attorneys charge $1,000 or more (fees have gone up substantially due to greater complexity of bankruptcy under the 2005 law). See above n 14 GAO Dollar Costs Report at 22–3 (noting median Chapter 7 attorney fee of over $1,000 for Chapter 7 in early 2007) and J Braucher, ‘A Fresh Start for Personal Bankruptcy Reform: The Need for Simplification and A Single Portal’ (2006) 55 American University Law Review 1295, 1308–11 and fn 65 (listing new paperwork and other burdens and quoting one lawyer as saying his fees had doubled). Debtors also must get a briefing about credit counseling and take a short course on financial management, requirements that cost debtors’ time as well as money; the monetary cost has been relatively small—approximately $50 or less for each required session, with fee waivers given in some cases. General Accounting Office, GAO report number GAO-07-778T, Bankruptcy Reform: Value of Credit Counseling Requirement Is Not Clear (released on 1 May 2007), available at <http://www.gao.gov/htext/d07778t.html>.

$^{37}$ The threshold in 2006–07 was A$38,510.50. Australian Government, Annual Report by the Inspector-General in Bankruptcy on the Operation of the Bankruptcy Act, 2006–2007. By keeping the assessment period for surplus income short and allowing debtors to keep half their income above a threshold, feasibility of repayment is enhanced and some debtors with above average expenses are accommodated.

$^{38}$ Bankruptcy Act 1966 (Cth), Part IX.

$^{39}$ Above n 8 at 362 (a simple majority in value of claims as of 2007). A third type, a personal insolvency agreement, is used by a small number of high-income debtors.

income contribution. Income contributions (including voluntary ones) collected from debtors in bankruptcy in 2006–07 equaled nearly A$19 million.

Other notable features of Australian bankruptcy are that debtors do not pay a filing fee and that they do not need professionals to access the system, keeping administrative costs charged to them quite low (zero for most debtors). In 2006–07, 88 percent of bankruptcies were administered by the government’s Official Trustee and the remainder by private trustees.

As for DAs, in 2006–07, debtors proposed 9,187 cases (just under 28 percent of the total of bankruptcies and proposed DAs); of those proposals, 6,516 were accepted (just under 71 percent) by creditors and became DAs. Accepted DAs, including those from prior years, resulted in dividends in 2006–07 of A$27,336,805. Indeed, a key factor used to support continuation of the DA option is that as of 2005–06, this option, despite the smaller number of cases in it, began producing more dividends for creditors than the bankruptcy option’s surplus income contributions, a point noted by the Inspector General’s report.

Dividend figures for 2005–06 were A$33 million from bankruptcies, over A$38 million from DAs, and nearly A$9 million from personal insolvency agreements, the more expensive form of proceeding used by a small number of upper income debtors. For DAs completed in 2005–06, the average rate of repayment in completed plans was 45 percent. This figure went up to 70 percent in 2006–07. These average repayment percentage figures leave out proposals never accepted and plans accepted by creditors but not completed by debtors, suggesting that the government has chosen to quote figures that portray DA success rates in the most favorable light; presumably there is no return from proposed DAs rejected by creditors, and the extent of returns for incomplete DAs is not clear.

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41 Above n 37 at 22, Table 14. Liability for surplus income does not necessarily mean success in repaying it. On the other hand, since the standard period until discharge is three years, debtors can pay their surplus income requirements, assessed for 12 months, over a longer period. See Duns and Mason, Consumer Insolvency in Australia, above n 7, at 217, 221.

42 The exact figure was A$18,707,477. Above n 37 at 22, Table 14 (adding contributions collected from the official trustee and registered trustees).

43 See JS Ziegel, _Comparative Consumer Insolvency Regimes—A Canadian Perspective_ 97 (Oxford and Portland, OR, Hart Publishing, 2003) (noting it is common for Australian debtors to get welfare workers and non-profit debt counseling agencies to assist them with forms).

44 Above n 37 at 1.

45 Ibid at 30, Table 22. The percentage figure for accepted proposals reflects not just creditor disapproval but also failures to satisfy the official receiver. Furthermore, government calendar year figures for acceptance of proposals leave out proposals accepted in the next calendar year (but capture acceptances of proposals made in the previous year).

46 Ibid at 32, Table 24 (compiled from information provided by debt agreement administrators). This figure was down from 2005–06, as were surplus income returns in bankruptcy, although creditor returns from DAs were greater in both years than from bankruptcies.


48 Ibid.

49 Ibid at 34, Table 25, and above n 8 at 370, Table 17.3.

50 Above n 37 at 32, Table 24.
In Australian government reports there is no focus on tallying relative administrative costs of the two main consumer options. Debtors do not have to pay filing fees for either bankruptcy or DAs. But while most debtors do not pay professionals to access bankruptcy, the picture is different for DAs, administered mainly by private practitioners, with the Official Trustee administering less than 1 percent of new agreements. A government review in 2005 found that commercial DA administrators charge high fees; fees of as much as A$3,500 have been reported. It should be understood that the whole DA regime has recently been changed to more heavily regulate DA administrators and that practices are somewhat in flux; numbers of DAs have been rising, but repayment expectations are declining, reflecting greater realism about the achievable.

Like Australia, Canada has both a surplus income contribution requirement in bankruptcy and a repayment option known as a proposal. In 2007, there were 79,796 consumer bankruptcy cases filed and 19,486 consumer proposals (just under 20 percent of the total of consumer bankruptcies and proposals). In 2005, the number of consumer bankruptcy cases was a little higher, 84,590, with 18,138 of those (over 21 percent) required to pay surplus income. The median and mean monthly amounts of surplus income that these 2005 consumer debtors were required to pay were C$180 and $243. Debtors who have a surplus of more than C$100 and less than C$1,000 must pay one half the surplus for nine months; if surplus income is C$1,000 or more a month, debtors must pay at least 50 percent but the trustee may increase that up to 75 percent.

Interestingly, of the 2005 Canadian debtors with surplus income liability, nearly 45 percent paid more than required; the reason was to pay trustee fees, usually C$1,800, in nine months. Indeed, going back a few years, to a 2001

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51 See above n 43 at 46 and above n 8 at [Manuscript p.] 6.
52 Above n 37 at 1.
55 See Australian Government, Annual Report by the Inspector-General in Bankruptcy on the Operation of the Bankruptcy Act, 2007–2008 at 36–42 and Table 23 (discussing increase in numbers of accepted DAs, with creditors agreeing to partial repayment, and more stringent regulation of DA administrators under changes in the law implemented in July 2007).
58 Ibid at 207 (Table 4).
59 Ibid at 203–5 (describing how surplus income is determined, starting with a low income standard). Legislation to raise from 9 to 21 months the period of contribution was not implemented. Ibid at 196, n 2.
60 Ibid at 208–209.
study, indications are that disbursements from estates for trustee fees are nearly four times disbursements to creditors. Professor Jacob Ziegel, a leading Canadian bankruptcy scholar, concluded that creditors gain ‘trivial benefits’ from surplus income payments but support the requirement as a way of ‘sending a message’ that debtors cannot simply walk away from their obligations.

Canada’s just under 20 percent usage of consumer proposals by consumer debtors in 2007 is lower than the 39 percent use of Chapter 13 by US consumer debtors and about 28 percent use of DAs by Australian consumer debtors in the same period, but proposal use in Canada has been going up in response to the surplus income requirement added to bankruptcy in 1997 and increase of trustee fees for proposals in 1998. A study of 1998 Canadian cases indicated that median monthly payments in proposals were C$290, compared to C$180 for monthly surplus income payments.

European countries began adopting personal insolvency regimes in the 1980s and have amended them frequently. A debt adjustment plan involving payment from income, often for a long period, was once the only option in Europe, but recent reforms, such as those in France and Sweden, permit some of the worst-off debtors to get a quick discharge without any attempt at repayment. Although the reforms reflected perceptions that many debtors cannot manage even partial repayment, there has been little empirical research in Europe on success in completing repayment plans. About 60 to 70 percent of debtors who seek debt relief under the highly discretionary French system, run by local commissions, are induced to enter into voluntary agreements with creditors, but apparently no data are collected on performance in these plans; there is reason to suspect that many are unrealistic and fail. Negotiated plans are often very long (10 years is the legal maximum in France, but subject to

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61 Ibid at 209.
63 Above at n 56 (19,486 out of 99,282 total Canadian consumer cases). See above nn 31 and 45 (concerning usage of Chapter 13 in US and DAs in Australia).
64 Above n 43 at 46.
65 Ibid at 48 and fn 164 (referring to study cited at 46, fn 149).
66 Denmark was first, in 1984. JJ Kilborn, Comparative Consumer Bankruptcy (Durham, NC, Carolina Academic Press, 2007) 11.
67 See ibid at 77.
68 Ibid at 69 (noting that in first few years after implementation of a new law in 2004, about a third of French debtors who were unsuccessful in negotiating plans with creditors were allowed to go into a ‘personal recovery’ proceeding not requiring repayment, based on a determination that even a 10-year plan would not permit repayment of any significant portion of debt) and 94–95 (concerning approval for some Swedish debtors of a ‘zero proposal’ based on finding inability to pay, which may occur in as many as a third of formal debt-relief cases, although there are few publicly available statistics). See also above n 3, at 48–9 (describing European preference for ‘soft,’ meaning voluntary, debt settlement but low rates of success in some countries).
69 See JJ Kilborn, ‘Continuity, Change and Innovation in Emerging Consumer Bankruptcy Systems: Belgium and Luxembourg’ (2006) 14 American Bankruptcy Institute Law Review 69, 71–4 (describing the French commission system, which pushes for negotiated plans, and only if that process fails recommends court-imposed plans or alternatives involving either a moratorium or immediate debt relief). See also above n 66 at 30–1.
extension to attempt to save a home); in addition, French voluntary plans also involve little or no forgiveness of debt and only modest interest rate reductions, and have been based on very stringent budgets, although since 1999 plans must leave debtors with the income protected by exemption law.\(^{70}\)

When creditors do not agree to a plan, French courts can impose limited debt relief in a court-supervised plan.\(^{71}\) Failure to complete both voluntary and imposed plans appears to be common, with two more layers of relief possible, either an ‘extraordinary’ moratorium on repayment for two years (followed by a fresh assessment of ability to repay) or, since 2004, a ‘personal recovery’ procedure not requiring repayment.\(^{72}\) A key point for present purposes is that data have not been collected in France on how much repayment to creditors actually occurs in this system and how much the system costs all concerned. In Europe, debtors typically do not have to pay for attempts at informal debt adjustment or even for court-ordered proceedings.\(^{73}\)

The German system also begins with attempts at negotiated settlement through state-supported debt advice centers that in recent years have had long waiting lists for debtors seeking relief.\(^{74}\) Success rates in brokering out-of-court arrangements have varied widely, from 11 to 54 percent of cases in various German states; success in reaching agreement, however, does not necessarily mean agreements are carried out; as in France, apparently no statistics are gathered on performance of agreements.\(^{75}\) For German debtors unable to make agreements with creditors, in theory the court-driven part of the process begins with another attempt to negotiate a plan, but since 2001 this step is optional and usually skipped as infeasible.\(^{76}\) After liquidation of any nonexempt assets, debtors enter a six-year ‘good behavior period’ to earn a discharge; they must turn over nonexempt income and make efforts to find and keep employment, including outside their training.\(^{77}\) Apparently most debtors pay nothing to creditors during the six years because they have no nonexempt income (and exemptions were raised beginning in 2002); also, challenges to discharge based on insufficient effort to find employment seem to be rare.\(^{78}\)

European countries often subsidize debtors’ costs in debt adjustment proceedings, but a reform involving cost-shifting to creditors has been adopted in Belgium. Debt mediators there fashion consumer debt relief proposals, with

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\(^{70}\) Ibid.

\(^{71}\) Ibid at 63–4 (concerning court power to order extensions, interest rate reductions and full or partial forgiveness of a deficiency left after foreclosure sale of a home).

\(^{72}\) Ibid at 63–70.

\(^{73}\) Above n 3 at 56–7.

\(^{74}\) Above n 66 at 40–1.


\(^{76}\) Above n 66 at 77–8.

\(^{77}\) Ibid at 78–9.

\(^{78}\) Above n 75 at 285–6, 290–1.
their fees paid in resulting plans in priority to all other debts. If debtors are unable to pay the mediator’s fee in full, the fee is paid from a fund financed by a tax assessed on the portion of consumer lending portfolios in default, a tax on creditors intended to create incentives for better underwriting. In 2003, about 11 percent of Belgian cases involved symbolic plans that could not even pay mediators’ fees, with the fee per case of about $1,250 (converting to US dollars) paid from the creditor-financed fund. The fund is also being used for a campaign to inform Belgians about their consumer debt relief law and to sensitize them about the problem of overindebtedness.

III. RATES OF DISCHARGE

A universal goal of consumer debt adjustment and bankruptcy systems is debt relief by discharge of debts, particularly debt that is beyond debtors’ capacity to repay. The conventional reasons for discharge include unleashing productive energy of debtors, whose incentives to work are dampened when large portions of income go to repay old debts, and alleviation of suffering of families stressed by constant hounding from aggressive debt collectors.

For repayment forms of bankruptcy that require completion of a plan to get a discharge, a key figure is what percentage of debtors who attempt plans complete them. High rates of plan completion and discharge are indicators of a realistic system, although there is a tradeoff with the first goal, creditor repayment. When debtors are required to pay more to get a discharge, more are likely to fail, but they may pay more to creditors in the meantime. There are also tradeoffs with out-of-bankruptcy repayment because the harder it is to access a bankruptcy system, the more debtors may pay either because they delay accessing the system or do not use it at all. Although lack of access to a discharge does not magically make debtors capable of repaying all debts, it does leave them subject to collection efforts and thus likely to make somewhat larger partial repayment.

A good start when evaluating repayment plan options would be data on length of time to discharge and percentage of debtors who get a discharge at all, acknowledging that a discharge rate of 100 percent may be undesirable because bankruptcy systems should exert pressure to repay in and out of bankruptcy. On the other hand, high non-completion rates (such as half or more of all plans) suggest that a system has unrealistic repayment requirements and fails to provide needed debt relief.

Debtors in repayment forms of bankruptcy in the US, Canada and Australia typically do not obtain a discharge in that option unless they complete their

79 Above n 69 at 81, 103.
80 Ibid at 103–5.
81 Ibid at 105–6.
82 Ibid at 106.
plans. In the US, it is striking that two-thirds of debtors who filed in Chapter 13 prior to the changes implemented in 2005 did not complete their plans.

Completion rates are similar for DAs in Australia and a little better in Canada for consumer proposals. The number of DAs proposed by Australian debtors in 2006–07 was 9,187; of those proposals, 6,516 were accepted (about 71 percent) by creditors. This means that 29 percent of cases failed at this initial stage. Making a proposal, even if not accepted by creditors, is recorded in a public record. The Australian government tracks completion rates for DAs, meaning cases accepted by creditors, which makes for numbers that overstate the success rate for proposed DAs as a whole. Government data show completion rates slightly above 50 percent for DAs (accepted proposals) entered into in 2001–02 and 2002–03 as of four or five years later. If one adds back in the proposals made by debtors but not accepted by creditors, the completion rates are much lower, 32 percent for the 2001–02 cases and a little over 37 percent for the 2002–03 cases.

Canada’s Personal Insolvency Task Force, in its 2002 final report, suggested that plan completion rates were in the 50 percent range, somewhat better than the one-third rate in the US and the 32 to 37 percent rate in Australia in the period 2001–03.

As noted in the last section, European countries do not seem to collect data on successful completion either of out-of-court or court-imposed repayment plans. Nor do they tally how many debtors who seek debt relief ultimately get a discharge.

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83 Australia previously gave a discharge when a proposal was accepted as a DA and recorded in a public record, but as of the 2007 amendments, the discharge is given on completion of the DA. See <http://www.itsa.gov.au/dir228/itsaweb.nsf/docindex/debt+agreements-%3Econsequences-%3Econsequences/opendocument> and issuance of an Official Receiver Certificate (in website page concerning consequences of a DA, noting change under 2007 amendments to make discharge effective on completion of a DA, rather than as under prior law, upon recording of the debt agreement in a public record).

84 Above n 16 at 518. See also above n 32, Report of the National Bankruptcy Review Commission at 90 (noting 32 percent completion rate for Chapter 13 plans). Yet to be determined is whether this rate of noncompletion of Chapter 13 plans will change under the 2005 law, which is exceedingly complex, making predictions difficult.

85 Above n 37 at 30, Table 22.

86 Above n 53 at 8 (noting that proposals are recorded on the National Personal Insolvency Index, which is a public record of insolvency events).

87 Ibid at 15 (for DAs made in 2001–02, after 40 months, about a third of debtors had completed payments, a third had been formally terminated and the last third remained in place, although the government reported that those cases may have reflected debtors who were no longer making payments but whose cases had not been terminated).

88 Above n 37 at 34, Table 26.

89 See ibid.

90 Personal Insolvency Task Force Annual Report 1 (August 2002) (concerning formation of the PITF as an advisory group to the Canadian Superintendent of Bankruptcy in the fall of 2000).

91 Ibid at 5, n 7 (finding that for cases filed between 1 May 1998 and 31 December 2000, the failure rate as of 20 June 2002 was 31.5 percent, with 20.9 percent completed and 47.5 percent still pending).
IV. TREATMENT

Communitarian and moral views of overindebtedness, particularly in Europe, have emphasized social dysfunction as a cause of the problem and treatment, using social workers and counselors, as an important part of the cure. Although social work is a focus in theory, recent reforms seem to be reducing the role of social workers in debt adjustment.\(^92\) The communitarian view in Europe is associated with allegiance to social welfare systems. When individuals have good health and unemployment insurance, there is less apparent justification for debt trouble; furthermore, high debt burdens mean government benefits do not support individuals who lose their jobs or cannot work due to illness. Overindebtedness thus threatens the social solidarity that a welfare system is designed to sustain.\(^93\)

A key question about treatment approaches is whether persons with debt problems in fact have other problems to a greater extent than others. In Europe it has long been assumed that the answer is yes and that debtors’ problems range from difficulty ordering their financial lives due to lack of self-discipline and financial management skills to more serious problems such as drug and alcohol addiction, family instability and domestic violence.\(^94\) Even if social problems and overindebtedness did at one time go together, as the supply of high-cost credit expands around the world, we may be seeing more people getting into debt trouble without having other problems first. If only small numbers of the overindebted need social work, perhaps treatment should be focused more on financial management skills. However, it tends to be assumed rather than empirically demonstrated that credit counseling and financial education are efficacious in preventing or curing overindebtedness.\(^95\) Financial education may

\(^92\) Above n 3 at 30–2, discussing history of individual debt counseling in Europe (long before debt adjustment systems began) and use of social work in that process. They note: ‘The traditional debt counseling paid much attention to the ability of the debtor household to follow a budget. The counselor was expected to give psychological support, to direct the debtor to appropriate services, to give advice on available social security benefits and to monitor the payment plan. As the European Study on Legislation notes, this social work aspect of debt counseling has diminished as the preparation for a filing has become more central.’ See also N Huls et al, ‘Can Voluntary Debt Settlement and Consumer Bankruptcy Coexist? The Development of Dutch Insolvency Law’ in J Niemi-Kiesiläinen et al (eds), Consumer Bankruptcy in Global Perspective 303–5, 308 (Oxford and Portland, OR, Hart Publishing, 2003) (concerning counseling debtors to seek help for personal problems and substance addictions).

\(^93\) See above n 1.

\(^94\) The idea that other problems drive debt predates adoption of consumer insolvency regimes in Europe. See N Huls et al, Overindebtedness of consumers in the EC member states: facts and the search for solutions (1994 report commissioned by the Consumer Policy Service of the Commission of the European Communities, distributed by Kluwer Editions Juridiques Belguque) at 12, ‘Drawing on the experience of years of debt counseling for hundreds of thousands of debtors, the German welfare and consumer organizations start from the assumption that overindebtedness is, in most cases, not the cause of a problematic personal situation. It is both a symptom and aggravating factor in that situation.’

not be enough to counteract aggressive marketing and confusion caused by the growing complexity of consumer credit products. Regulation of credit products to promote simplicity and thus transparency may be more realistic than a major campaign for ‘financial literacy.’

There is also a question whether generalized social dysfunction manifests itself in many problems, including overindebtedness, or whether debt causes other problems. Causation may run both ways, making design of effective treatment complex.

Even in systems that have not emphasized treatment, such as the US system, there is a trend in that direction, but so far extending only to credit counseling and financial education. Thinking of debtors as deviants has a long history in the US, but in the late 20th century, this perspective became a minority view, so much so that there is now no focus in the US on studying whether debtors tend to have other problems. Mandatory briefings on credit counseling and required short courses in financial management, added to US bankruptcy law in 2005, are to a great extent cleverly designed hurdles to access to bankruptcy and discharge, but their usefulness as political cover for efforts to limit access to debt relief may show there is a sense that counseling and education are needed, although there is little evidence these approaches help debtors avoid future problems. Mandated evaluation of the new requirements may be limited to having debtors fill out forms about their satisfaction at the end of programs, an approach that will not gauge whether there is any lasting behavioral change.

Academic studies suggest that US bankruptcy is far from completely effective even in treating debt problems, let alone other problems (if any, because whether debtors have other social problems has not been a focus of research). A survey of Chapter 7 debtors one year after filing found that one in four was struggling to pay routine bills and one in three reported an overall financial situation similar to or worse than when they had filed. The Velkey and Norberg study of Chapter 13 debtors found that at least half of their sample had filed at

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96 Above n 2 at 344–5 (noting that financial education is up against sophisticated marketing that makes consumer culture so appealing).
97 Above n 95, Willis.
98 Above n 32, Report of the National Bankruptcy Review Commission at 84, 86–7 (tracing increase in use of bankruptcy to huge increase in supply of consumer credit and declining to adopt view that ‘social factors’ and reduced stigma were the cause); see also R Efrat, ‘The Evolution of Bankruptcy Stigma’ (2006) 7 Theoretical Inquiries in Law 365 (2006) (study of change toward more sympathetic portrayals of debtors in newspaper articles).
99 11 USC § 109(h) (briefing on credit counseling as eligibility requirement) and §§ 727(a)(11), 1328(g) (debtor education as condition of discharge).
101 11 USC § 111(d) (concerning regulation of providers of credit counseling and financial education).
102 Above n 11, Porter and Thorne.
least one other bankruptcy case, most commonly another Chapter 13, indicating a lack of lasting debt relief.

A treatment goal is not met if debtors’ problems with debt recur, something that deserves more study. One of the problems with getting at success in treatment is that continuing problems may be due to a failure of a given system to provide adequate debt relief rather than from a failure to educate or treat social ills. If a debtor emerges from bankruptcy or debt adjustment with a great deal of nondischargeable debt or no discharge at all, it is unsurprising that debt problems continue. Even if a debtor gets a full discharge, the recurring problems could be due to lack of reasonable prospects for a living wage (perhaps in turn caused by lack of marketable job skills) rather than lack of financial management skills.

Thus, it would be useful to study debtors longitudinally. Data should be gathered on debtors’ financial stability over time to learn to what extent they have recurring problems with debt and whether those problems are caused by deficiencies in financial management as opposed to low income or lack of full debt relief in a bankruptcy or debt adjustment plan. A cure does not just alleviate symptoms temporarily. When significant numbers of debtors enter plans that fail or are back in debt trouble soon, overindebtedness is not being treated effectively.

Treatment is the goal of European debt adjustment systems, yet there has been little effort to gauge whether debtors are in fact ‘cured,’ whether of debt problems or other social ills. Professor Jason Kilborn quotes a German legislator and former bankruptcy judge, Alfred Hartenbach, as follows concerning the benefits of the German consumer insolvency regime:

The people get something from it, as their feeling of self-worth rises. The children of these people get something from it, as it must be, I believe, one of the worst experiences when one must grow up in an overindebted household as a child in poverty.

Kilborn points out that creditors are not listed as beneficiaries, and with good reason, because German insolvency proceedings do not produce much repayment. The hope of the German system is that debtors subjected to a six-year ‘good behavior’ period will be inculcated in an ethos of financial responsibility. Whether benefits to debtors and their children are in fact achieved bears investigation.

The system in the Netherlands provides a similar example, reflecting a typical European preference for informal voluntary debt settlement, with troubled debtors going to local debt management agencies funded by municipalities.

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103 Above n 16 at 496–7, 50 (also noting that repeat filing figure is probably understated for several reasons, including lack of electronic records going back into the 1980s and that repeat cases filed after 2002 were not captured).


105 Above n 75 at 294 and fn 237.

106 Ibid at 294–5.

107 Ibid at 295–6.

108 Above n 92, Huls et al, at 303.
The Dutch consumer bankruptcy act has had an unintended consequence of reducing the success of local agencies in negotiating settlements for a variety of reasons; while this decline in ‘success’ in reaching agreement has been studied, what has not been studied is whether debtors who enter into voluntary plans are able to pay as agreed. Local agencies not only negotiate voluntary plans but many also offer a full range of services, attempting to get debtors to reorder their lives by taking financial management courses, cutting back on unnecessary expenses and starting to save and also by entering into counseling, if needed, for alcohol and drug addiction or personal problems. We do not know how successful treatment efforts are in producing a cure that lasts.

V. RATIONAL SORTING

Rational sorting is a principle to reconcile to the greatest extent possible the three goals already discussed, creditor repayment at lowest administrative cost, debtor discharge and treatment. Consumer bankruptcy and insolvency systems typically have more than one option, with some debtors expected to pay more than others to get a discharge. Sorting among options is rational when those able to repay more of their old debt are directed to options requiring more repayment, while those able to repay little or nothing get a discharge more quickly. This type of sorting maximizes repayment and discharge and also treatment, both in the sense of learning financial responsibility where feasible and quickly getting debtors on a sustainable budget.

Rational sorting puts debtors into repayment plans only when they have excess income over reasonable current expenses. More controversial is whether to take debt load into account because having a lower debt-to-income ratio is a good indicator of ability to repay more old debt. On the other hand, means testing that takes debt-to-income ratio into account is subject to the criticism that it rewards the improvident over those who were relatively prudent. A system avoids this problem by basing surplus income contributions only on income and ‘reasonable’ expenses, leaving out debt burdens.

109 Ibid at 306 (reporting declining rates of success in negotiating voluntary debt settlements) and 309–10 (setting forth some reasons creditors prefer judicial debt adjustment, including high failure rates that leave debtors subject to collection again and debtor shame about using judicial debt adjustment, so that some do not pursue it when creditors refuse a voluntary settlement).

110 Ibid at 304–5, 308.

111 US means testing system takes debt load into account, particularly secured debt, so that it is easier to pass the means test (used to screen debtors out of Chapter 7) if one has more secured debt: 11 USC § 707(b)(2)(A)(iii). Australia, in contrast, figures surplus income contributions based on income above a fairly low threshold and assumptions about reasonable expenses and requires payment of half the surplus income thus computed for 12 months; a hardship appeal is necessary to deal with higher reasonable expenses. See above n 7, J Duns and R Mason, ‘Consumer Insolvency in Australia’ at 214–16 (discussing § 139T hardship appeals under the Bankruptcy Act for such items as medical expense and child care and transportation expense necessary for work and noting that 42 appeals were brought in 1999–2000 and 19 were successful).
Another issue is whether to use a standard set of reasonable expenses, rather than case-by-case review. Both systems have problems; a standard set of expenses does not account for those with higher but justified expenses, but case-by-case review is more costly for all concerned. Using a standard set of expenses, subject to special pleading, may be the best that can be done, although this adds complexity and expense for outliers.112

Although rational sorting has many nuances, rough evaluation for signs of trouble is not hard. When debtors in different options do not show different characteristics in their financial profiles, there is reason to doubt that rational (or fair) sorting is achieved. More specifically, when debtors with relatively low income and higher debt end up in repayment plans, there is cause for concern about perverse or random sorting. These debtors may not understand their alternatives or be overoptimistic about their ability to repay; professionals may have steered them inappropriately, seeking fees or due to wishful thinking about what is realistic.

The systems in the US, Canada, and Australia all suffer from irrational sorting among options. Complexity of these systems makes it hard for consumer debtors to understand their options. Also, in all three countries some professionals (lawyers in the US, accountants in Canada or DA administrators in Australia) are not doing a good job of guiding debtors to the appropriate choice, as opposed to acting in their own self-interest or pursuing their own policy preferences. This section will focus on sorting in the US and Australia as examples; good accounts of the sorting problem in Canada are available elsewhere.113 In addition, Europe has a problem with efficiency of sorting due to a tendency to require attempts at negotiated settlements or court-ordered plans by all debtors, with some movement toward immediate debt relief for those with no hope of repaying old debt.114

As has been noted, prior to the new US law, Chapter 13 had about a two-thirds noncompletion rate,115 meaning debtors did not get a discharge unless they filed again or converted to Chapter 7. In addition, low incomes and high debts of many Chapter 13 debtors suggested a lack of rational sorting between the chapters. In 1994, when US median gross household income was just over $38,000, household income of debtors in Chapter 13 was a little over $22,300 at the median and under $26,500 at the 75th percentile and just over $13,000 at the 25th percentile.116 In

112 Ibid (concerning hardship appeals).
113 See Iain Ramsay, ‘Market Imperatives, Professional Discretion and the Role of Intermediaries in Consumer Bankruptcy: A Comparative Study of the Canadian Trustee in Bankruptcy’ (2000) 74 American Bankruptcy Law Journal 399. See also above n 43 at 47–8 (finding that debtors in consumer proposals have low incomes and high debts, but somewhat higher incomes than those who file in bankruptcy) and 18–19 (concerning conflict of interest problem with trustees who advertise to serve consumers but are legally accountable to creditors).
114 Above n 3, Niemi-Kiesiläinen and Henrikson at 48–50 (concerning preference for voluntary settlements) and above n 58 (noting legislative changes to allow quicker discharge).
115 Above n 84.
116 See above n 16 at 487.
sum, debtors in Chapter 13 were mainly poor and near poor. Their debts, however, were substantial, with a median debt to net income ratio (excluding long-term mortgage debt) of .965 and 75th and 25th percentile ratios of 1.699 and .558.117 Thus, the median Chapter 13 debtor owed about a year’s take-home pay to non-mortgage debt, and even the 25th percentile debtor owed over six months net income for non-mortgage debt.

The 2005 US bankruptcy reforms nominally had an objective of ‘abuse prevention,’ but the more obvious problem with the system at that time was irrational sorting, particularly pushing debtors without means into Chapter 13. It should be noted that neither the reduction in bankruptcy filings overall since 2005 nor the increased proportional use of Chapter 13 since the new law went into effect necessarily increases rational sorting. The cost of bankruptcy has gone up in myriad ways, from filing fees and attorneys’ fees to gathering extra paperwork; increased costs predictably depress access to bankruptcy.118 Some lawyers have stopped practicing bankruptcy law because of added complexity.119

Most debtors using Chapter 13 since 2005 are not being pushed there by Chapter 7 means testing, under which debtors cannot be presumed abusers unless they are above median income for their state and family size.120 The United States Trustee Program collected data concerning means testing implementation from October 2005 to March 2007.121 It found that only 27 percent of Chapter 13 debtors were above median income, while in Chapter 7, about 8 percent were above median income, but most of those still passed means testing; the trustee was challenging only about one in 140 Chapter 7 cases as involving abuse (well under 1 percent), up from one in 274 cases prior to the new law.122

More than 90 percent of above-median-income debtors who filed in Chapter 7 passed the means test because of available deductions, such as for secured debts.123 Being above-median income emphatically does not mean a debtor necessarily must file in Chapter 13. Probably most of the 27 percent of Chapter 13 debtors with above-median income could have passed the presumed abuse test in Chapter 7; more were likely in Chapter 13 to save homes and cars on which they had arrearages, or perhaps for no reason other than steering by their

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117 Ibid at 491.
118 Above n 36, Braucher at 1305–15 (concerning new burdens on and hurdles for debtors).
119 11 USC § 707(b)(4) (new attorney sanctions provisions). A phenomenon that deserves rigorous study is the extent to which lawyers have dropped out of consumer bankruptcy practice because of its greater complexity under the new US law and also because of the new attorney sanctions.
120 11 USC § 707(b)(2), (6), (7).
122 Ibid (figure for abuse challenges of 1 in 140 cases includes not just presumed abuse but also ‘totality of the circumstances’ or ‘good faith’ dismissal motions under 11 USCA § 707(b)(3)).
123 Ibid at § 707(b)(2)(A)(iii)(I) and above n 121 (9.5 percent of above median income Chapter 7 debtors were presumed abusive, but the trustee system did not challenge 20 percent of those, presumably because they could have rebutted the presumption of abuse).
lawyers. Some no doubt simply wanted to pay as much of their debt as they could, even if not required to do so.

Collateral retention is a particular obsession of the US system, in both Chapters 7 and 13, contributing to irrational sorting. US debtors who are not behind on payments can often retain collateral in Chapter 7, while those who have missed payments generally need Chapter 13 to do so. As a result, some of the worst-off debtors end up in Chapter 13 to hold on to homes and cars. We lack information about how successful debtors are in retaining collateral.

Some Chapter 13 debtors have a fundamental problem of not being able to afford their homes or cars and might be better off giving them up, quickly getting a discharge in Chapter 7, and adopting a workable budget.

In Australia, proposed DAs have either not been accepted or not completed at high rates, meaning no discharge, although completion rates may be improving. Australian law does not require a minimum income for a DA and instead sets up an indexed maximum income and indexed maximum debts and assets. The income limit was raised by amendments in 2003, and as of February 2008, a debtor was eligible for a DA with income after taxes of less than A$59,186.40, and unsecured debts and nonexempt property each of less than A$78,915.20.

Key information to gauge rational sorting is the relative incomes of Australian debtors in bankruptcy as opposed to DAs and their debt-to-income.
ratios. Although the government annual reports do not report comparative income and debt data for debtors in bankruptcy and DAs, ITSA reviews of debtors who entered DAs in 2003 and 2005 found that more than half had gross incomes of less than $30,000, which means they could easily have qualified for straight bankruptcy with no surplus income contribution. This would be a more reliable route to a discharge; some DA debtors end up using bankruptcy, but after delay and added cost to try a DA.

Among Australian debtors filing in bankruptcy, there has been a significant change since 1999 in the percentage of debtors liable to contribute surplus income. Rounded to whole numbers, 15 percent were liable to pay surplus income in 2006–07, up from 12 percent the year before and more than twice the percentage (7 percent) found liable for a contribution in 2001–02 and five times the number liable in 1999–2000 (3 percent). The change could reflect both use of DAs by low-income debtors who would not be liable for surplus income contributions in bankruptcy and more debt problems resulting in bankruptcy among debtors above the surplus income threshold.

Problems noted in the Australian DA system in a 2005 ITSA review include: emergence of a private industry of ‘debt administrators’ with high fees, high pressure, and lack of debtor understanding; criticism by nonprofit financial counselors (suggesting that informal repayment plans rather than DAs might work better for debtors and creditors); lack of confidence in the system among creditors; high failure rates for DAs, although as noted above in Part III, this may have improved somewhat; largely the same consequences for debtors in credit standing from straight bankruptcy (because making of a proposal and its acceptance are listed in the public record).

These problems led to new DA regulation, effective 1 July 2007. The changes focus on regulation of DA administrators, who now must be licensed, whose fees must be paid over the life of the DA (and not in priority to creditors, although upfront fees are still permitted), and who must make required disclosures to debtors. It is an open question whether these changes will be sufficient to root out problems in the DA system, originally envisioned as an option where debtors could use relatives or friends, not commercial administrators, to help them come up with proposals. Probably the most important of the

134 Above n 8 at 359 (concerning 2005 cases) and n 53 at 10 (concerning 2003 cases).
136 See above at n 89 (concerning increase in completion rate from 32 percent in 2001–02 to over 37 percent in 2002–03).
137 Above n 53 at 8.
138 Bankruptcy Legislation Amendments (Debt Agreements) Act 2007 schedule 2 § 80. Above n 8 [at 14, n 33 in chapter MS].
140 Above n 8 at 364.
reforms is the regulation of timing of administrators’ fees, to reduce their incentives to guide debtors to make proposals unlikely to be accepted or completed.

Submissions made by interested parties to the 2005 ITSA review of DAs suggest that more extensive reform may have been needed. The Consumer Credit Legal Center Inc (CCLS) of New South Wales, a legal services organization specializing in consumer credit problems and policy, urged repeal of the DA part of the Australian Bankruptcy Act.141 Alternatively, CCLS recommended that debtors contemplating DAs should have to seek advice first from financial counselors (meaning a nonprofit counselor) and that DAs should be administered by ITSA on a cost-recovery basis, rather than by for-profit administrators. CCLS reported on its experiences with persons who had problems with DAs, including lack of consumer understanding of adverse effect on credit rating, unsustainable repayment amounts, upfront fees and high overall fees (for example, A$3,500), and difficulty getting out of DAs and into bankruptcy. CCLS also stressed that rejected proposals should be considered part of the failure rate.

CCLS made an interesting recommendation (not adopted) that a minimum income should be required for DAs to address the problem of low income, heavily indebted debtors entering into unrealistic DAs without understanding their alternatives. CCLS’s overall assessment was that instead of providing a low-cost alternative to bankruptcy, the DA is ‘a long and expensive path to eventual bankruptcy.’ Of course CCLS was unlikely to see debtors who succeeded in completing DAs, but its testimony is indicative of irrational sorting for some who make proposals.

Because Australia’s private DA administrators are not required to be registered trustees who can also handle bankruptcies,142 the incentives for steering may be worse in Australia than in the US, where some attorneys have tended to steer clients into Chapter 13 out of self-interest or because of unrealistic views of what debtors can pay. Australia’s recent reforms did not address the structural problem of having for-profit administrators who support only one option, likely contributing to irrational sorting.

Overall, Australia seems to have a very effective low-cost bankruptcy option but its DA option is more troubled. The Australian system was once elegantly simple, cheap and effective at sorting debtors (based on surplus income) but adoption of American-style complexity of options has caused sorting problems. Greater creditor repayment has come at significant administrative cost and also with at best delay in debtor discharge and treatment.

Australian bankruptcy is undesirable for some debtors because of legal features such as investigation, examination and bans on practicing certain occupations.143 There seems to be no evidence, however, that these negative features

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141 Above n 54.
142 This continues to be true under the 2007 amendments. See above n 139 at 1.
of bankruptcy are what drive debtors into DAs. These features may be important in only a small number of cases, with many other debtors steered into DAs by commercial administrators without instrumental reasons for debtors to use that option. As in the US, a big reason for use of the repayment option may be debtors’ desire to do the right thing, with debtors not understanding that they will get the same black mark on their credit history, while also risking failure and no discharge.

Duns and Mason in their Chapter X conclude that debt agreements have been a ‘success story, as measured by the number being taken up and the average dividends being realized for creditors.’ Numbers have certainly gone up and returns to creditors (and administrative costs) are higher than in bankruptcy, but rates of non-acceptance and non-completion of DAs suggest that fewer should be proposed. Duns and Mason note legislative history concerning recent reforms indicating debtors are usually in a worse financial position when their agreements fail than at the start of the process.

Use of a repayment option by persons without sufficient means has also been a theme in the US, with its high non-completion rate in Chapter 13, and in European debt adjustment systems, which have gradually gotten more realistic, even offering immediate discharge to the worst off. Around the world, we see a convergence in sorting problems in increasingly complex bankruptcy systems.

VI. CONCLUSION

This Chapter has proposed three criteria for comparative evaluation of repayment forms of consumer debt proceedings: creditor repayment net of administrative costs, rates of discharge, and treatment that produces a cure. Available data, while spotty, suggest that repayment options in North America, Australia and Europe have high costs in relation to unsecured debt repayment and significant rates of failure to achieve a discharge. Rational sorting is a principle to maximize achieving all three goals, yet we see sorting problems in all these regions, with low-income debtors attempting and failing to complete plans. A significant hole in our knowledge is whether repayment options treat the problem of overindebtedness or instead leave many debtors struggling financially and perhaps in other ways, too. To evaluate systems in terms of results rather than aspirations, the essence of a law-in-action approach, we need a vast expansion in data collection by both governments and independent academic researchers.

144 Ibid at 364.
146 See above n 84.
147 See above nn 68, 72.
Debt Agreements Down Under

JOHN DUNS AND ROSALIND MASON

I. INTRODUCTION

IN 1996 AUSTRALIA introduced ‘debt agreements’ as an alternative to bankruptcy.¹ The debt agreement procedure was radical in a number of respects but most notably in terms of its simplicity, flexibility and informality. Now, with just over a decade of experience, significant reforms have recently been introduced but the regime itself appears to be entrenched. The purpose of this Chapter is to assess the Australian experience with debt agreements. What is their rationale? What are their distinguishing legal features? What are the outcomes for debtors and creditors?

We begin by considering the rationale for debt agreements. This looks at the policy underlying both alternatives to bankruptcy generally and the Australian debt agreement in particular. The next part examines the legal features of debt agreements, drawing comparisons with schemes in other jurisdictions, particularly the well-established Chapter 13 alternative in the United States Bankruptcy Code and the interesting new reforms in the United Kingdom.² Then, after

¹ There was at the time, and remains, another alternative to bankruptcy. This is the ‘personal insolvency agreement’, under Part X of the Bankruptcy Act 1966 (Cth) (hereinafter ‘Bankruptcy Act’). Because of the expenses associated with their administration, personal insolvency agreements have often not been an option taken up by consumer debtors. This was one of the main reasons cited for the introduction, and form, of the debt agreement procedure.

² These reforms are contained in Part 5 of the Tribunals, Courts and Enforcement Act 2007. The papers leading to these reforms are Department for Constitutional Affairs, A Choice of Paths (better options to manage overindebtedness and multiple debt) (Consultation Paper CP 23/04, 20 July 2004), Response paper on the consultation ‘A Choice of Paths—better options to manage overindebtedness and multiple debt’, Department for Constitutional Affairs (CP/R) 23/04 17 March 2005 and ‘Relief for the Indebted—An Alternative to Bankruptcy’ (March 2005). These papers are available at <www.dca.gov.uk>.

New Zealand has also proposed a ‘No Asset Procedure’ as an alternative to bankruptcy for consumer debtors. See Insolvency Law Act 2006 (NZ) Part 5, Subpart 4. For the background to this initiative, see Ministry of Economic Development, Draft Insolvency Law Reform Bill Discussion Document (April 2004). It is expected that the New Zealand amendments will commence at the end of 2007: <www.insolvency.govt.nz>.
briefly tracing the background to the introduction of debt agreements, the Chapter provides information about their use and problems that have emerged. The resulting reforms, introduced in April 2007 (including the introduction of a debt administrator registration system) and generally commencing in July 2007, are outlined. Finally, the paper concludes with some reflections on the Australian experience with debt agreements.

II. RATIONALE FOR DEBT AGREEMENTS

It is not self-evident that consumer debtors should be provided with an alternative to bankruptcy. Why not place all insolvent debtors into bankruptcy? Indeed, this has been argued. And it is true that, despite debate over the details of the proper scope and role of bankruptcy law, there is general agreement that it is a basic role of bankruptcy law to regulate a state of insolvency.

However there are a number of reasons why the ‘one size fits all’ approach of bankruptcy may not always be appropriate to regulate insolvent debtors. In principle, this arises when the legal features of bankruptcy are, for whatever reason, incompatible with the optimal treatment of the debtor’s insolvency. Given that the ground for bankruptcy, the debtor’s insolvency, is such a general one, it is hardly surprising if such an incompatibility arises. Insolvency is a broad, even vague, concept that catches disparate groups of debtors. Some debtors will be hopelessly insolvent, some will be temporarily or marginally insolvent, some will be insolvent for reasons totally beyond their control and others may be seeking to take advantage of the insolvency laws to avoid their liabilities. In this respect it is interesting to note that the latest United Kingdom reforms are (broadly) based on a more sophisticated categorisation of debtors. This categorisation drew on an empirical study of insolvent debtors in which insolvent debtors were classified into groups of ‘can’t pay’, ‘could pay’ and ‘won’t pay’.

5 In Australia, the ground for (compulsory) bankruptcy is an act of bankruptcy. Acts of bankruptcy are in effect proxies for insolvency. In practice a debtor’s failure to respond to a bankruptcy notice demanding payment is the act of bankruptcy that is overwhelmingly relied upon by creditors. This is likely to be a fair indicator of insolvency. Further, if the debtor is able to establish solvency, the court may reject the creditor’s bankruptcy petition: Bankruptcy Act s 52.
The key features of bankruptcy that may not be appropriate for some classes of insolvent debtors are:

- the automatic sequestration of the debtor’s property, including after-acquired property;
- the (often significant) delay in the availability of discharge; and
- the subjection of the debtor and the debtor’s financial affairs to investigation and examination.

A regime that excludes or modifies the above mentioned consequences might be more appropriate for some insolvent debtors. This is because:

(a) *an alternative regime may better promote debtor rehabilitation.* Where the debtor’s insolvency is only temporary, or has been caused by factors completely beyond the debtor’s control, debtor rehabilitation may be better achieved without the features of bankruptcy noted above. For example, rehabilitation may be more effective where property is left in the debtor’s hands, discharge is immediate and the requirement to investigate and examine is waived;

(b) *an alternative regime may offer greater returns to creditors.* Again, where the insolvency is marginal or temporary, an arrangement that allows the debtors to retain their property but gives them some breathing space to repay their debts may result in a greater return to creditors than is likely in bankruptcy.\(^8\)

(c) *bankruptcy consequences may be excessive.* Some consumer debtors may not require the investigation, examination, loss of privileges and employment opportunities etc that generally accompany bankruptcy. For such debtors, the full bankruptcy regime may be ‘overkill’ and hence costly and inefficient. For example, it may be more appropriate to acknowledge that many ‘can’t pay’ debtors should be dealt with expeditiously and simply and thus entitled to more or less immediate discharge from their debts.

For the above reasons it might be appropriate to offer alternative regimes to bankruptcy for some insolvent debtors. The idea would be to create different legal consequences for different types of insolvency. The introduction of debt agreements into Australia as an alternative to bankruptcy appears to have had, at least in part, some of these issues in mind. Debt agreements were introduced as a simple, informal alternative to bankruptcy for those debtors on low incomes, with relatively low levels of property and unsecured debt. In the Second Reading of the relevant Bill, the Attorney-General stated:

People who find themselves unable to pay all their debts or who may be unable to meet repayments due to a temporary change in income will no longer have to go bankrupt . . . .The proposed debt agreements provide a real improvement for low income debtors who are interested in meeting their obligations to

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\(^8\) There is a risk here that developing a regime primarily to help creditors will lead to inadequate protection of debtors. This has been one of the concerns in relation to debt agreements in Australia.
pay their debts. They should allow debtors the opportunity to obtain a ‘breathing space’, during which time they can explore opportunities for dealing with debts outside of bankruptcy. This will avoid the stigma that bankruptcy entails while, at the same time, encouraging practical arrangements with creditors likely to result in a better return for them.9

III. FEATURES OF THE AUSTRALIAN DEBT AGREEMENT REGIME

Debt agreements are available at no cost to debtors and their entry, processing and administration requirements are simple and streamlined. The process begins with a debtor ‘proposing’ a ‘debt agreement’ to creditors. The content of such an agreement is largely left to the debtor. The debtor’s proposal is processed administratively (that is, without court involvement) by a government body.10 If the proposal is accepted, moratorium and, ultimately, discharge provisions come into effect.

A. Pre-conditions to Entry

Debt agreements are available to individuals (including foreign citizens and minors) and partnerships, but not corporations.11 They are therefore available to unincorporated businesses although in practice, as explained below, they are typically used only by consumer debtors.

As from July 2007, it is no longer possible for two (or more) debtors to propose joint debt agreements. This amendment was introduced primarily to address the risk of injustice occurring should an agreement be terminated due to default by one debtor and not the other.12 However, conditional proposals are now possible, so that, for example, two spouses may make concurrent separate proposals relieving ‘the family unit from the burden of their shared joint debts’ that are conditional upon each other’s proposal being accepted.13

Some debtors are unable to propose a debt agreement. These disqualification provisions14 are designed to prevent abuse of the process. They (a) limit access to debtors who have previously used the regime (or other alternatives) and (b) deny access to debtors who exceed relatively low levels of income, property and debt.

In relation to the former, a debtor is unable to propose a debt agreement if they have, within the previous 10 years, (i) been bankrupt; (ii) been a party to a

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10 The relevant body is the Insolvency and Trustee Service Australia (ITSA), an executive agency of the Commonwealth (or Federal) Attorney-General’s Department.
11 Bankruptcy Act s 7.
12 Bankruptcy Act s 185C(2E) and House of Representatives, Bankruptcy Legislation Amendment (Debt Agreements) Bill 2007 Explanatory Memorandum (‘Explanatory Memorandum’), para 143.
13 Bankruptcy Act s 185C(2F) and Explanatory Memorandum, para 144.
14 Bankruptcy Act s 185C(4).
debt agreement; or (iii) authorised the use of a ‘personal insolvency agreement’. The 10-year time period is a comparatively long one. For example, the United States Chapter 13 preconditions disqualify debtors who:

(a) have had a bankruptcy petition dismissed in the prior 180 days if this was on the ground of the debtor’s wilful failure to appear before the court or comply with an order of the court or where the petition was voluntarily dismissed after creditors sought to recover property on which they hold liens;

(b) were discharged under Chapters 7, 11 or 12 within the previous four years. This contrasts with the precondition for bankruptcy under Chapter 7, which prevents a filing under Chapter 13 if the debtor previously filed within the prior 8 years;

(c) were discharged under Chapter 13 within the previous 2 years.

The time periods in the United Kingdom reforms are also considerably shorter than the Australian provisions.

As concerns disqualification for financial reasons, the debtor must meet limits imposed in relation to debt, property and income. Both unsecured debts and the value of debtor’s property (that is, if bankrupt) must not exceed the specified ‘threshold amount’. This threshold is currently A$75,075 or approximately US$63,921. The amount is indexed every six months in accordance with Consumer Price Index increases, which is far lower than the comparable United States figure. After tax income must not be likely to exceed 75 per cent of the threshold amount. In practice, this means that a debtor with a taxable income of over A$80,000 is eligible.

The ITSA Profile of Debtors who entered a debt agreement during 2005 found that 53 per cent had a gross income of less than A$30,000 (approx US$25,540) in the year prior to entering into the debt agreement. It also found that 48 per cent owed unsecured creditors less than A$20,000 (approx US$17,027), with 17 per

15 See n 1.

16 There is no such requirement for personal insolvency agreements under Part X. The only relevant restriction here is that, unless court approval is obtained, a debtor may give only one authority every six months to a trustee or solicitor under Part X, to call a meeting of creditors: Bankruptcy Act s 188(4). In relation to debtors’ petitions for voluntary bankruptcy, the Official Receiver has power to reject a petition if the debtor has previously presented a petition three times or has presented a petition within the previous five years: Bankruptcy Act s 55(3AA).

17 US Bankruptcy Code ss 109(g), 362(d) and (e).

18 See note 2.

19 In the case of Administration Orders, the disqualifying period is one year: s 112 AH of the County Courts Act 1984 (c 28) as amended by the Tribunals, Courts and Enforcement Act 2007. For a Debt Relief Order, the relevant period is six years: s 5 of Schedule 4ZA to the Insolvency Act (c 45) as amended by the Tribunals, Courts and Enforcement Act 2007.

20 See US Bankruptcy Code s 109(e) (an amount which is also adjusted periodically). For the relevant UK Debt Relief Orders, Part 1 of Schedule 4ZA of the Insolvency Act 1986, as amended by the Tribunals, Courts and Enforcement Act 2007, refers to a ‘prescribed amount’ The Department for Constitutional Affairs, Tribunals, Court and Enforcement Bill: Detailed Policy Statement on Delegated Powers. (December 2006) proposed that the maximum overall indebtedness be set at €15,000, the limit on property at €300 and the limit on monthly surplus income at €300.
cent owing less than A$10,000 (approx US$8,513); and 85 per cent had realisable assets less than A$1,000 (approx US$851).  

In contrast with the positions in both the United States (under Chapter 13) and the United Kingdom, there are no government fees to be paid by a debtor in entering a debt agreement, nor is there [stamp] duty on the agreement itself.  

In relation to debtor counselling, there is only a nominal requirement in the Australian provisions. Before processing a debt agreement, the Official Receiver or an administrator must give the debtor the information prescribed by the regulations. The prescribed information set out in the regulations simply refers to ‘information about’ alternatives, consequences and sources of financial advice. The government body responsible for bankruptcy administration has produced a pamphlet setting out the required information. The Official Receiver must not accept a proposal for processing unless the debtor has given a signed acknowledgment of having received and read the prescribed information. The 2005 ITSA Profiles of Debtors (released in 2006) shows that 57 per cent of debtors who made a debt agreement received advice from commercial debt agreement administrators, whereas only 5 per cent received advice from a financial counsellor.

This stands in contrast to the position under United States Chapter 13 where credit counselling, either individually or in groups, is generally required from an approved credit counselling agency. The United Kingdom Debt Relief Orders must be made through an ‘approved intermediary’, which is expected, at least initially, to be confined to those who currently give advice which is free to debtors.

B. Processing

The procedure involved in entering into a debt agreement has been one of utmost simplicity and, even though the July 2007 amendments, discussed below, have introduced new requirements, the process is intended to be much simpler

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21 This is based on data contained in the Statements of Affairs on the ITSA database for debtors who entered into Debt Agreements in 2005.

22 Bankruptcy Act s 185X. ITSA’s costs will in part be offset by the introduction of fees borne by creditors and debt agreement administrators. At the time of writing, the United Kingdom proposals are that the fee for a Debt Relief Order will be less than the fee for a debtor’s petition and is expected to be less than €100: Department for Constitutional Affairs, Tribunals, Court and Enforcement Bill: Detailed Policy Statement on Delegated Powers (December 2006), para 298.

23 Bankruptcy Act s 185E(1); 185C(2D) Bankruptcy Regulation 4.1.

24 This can be viewed on the ITSA website at <www.itsa.gov.au>.

25 This may be signed by another in cases of illiteracy, language problems etc: Bankruptcy Regulation 4.11(5).


27 Exceptions apply in the case of emergencies or if the trustee considers that there is no available agency. See US Bankruptcy Code ss 109, 111.

28 See Department for Constitutional Affairs, Tribunals, Court and Enforcement Bill: Detailed Policy Statement on Delegated Powers (December 2006), para 323.
than the alternatives of a personal insolvency agreement or bankruptcy. Because of the significance of the 2007 amendments to processing of debt agreements, the pre- and post-July 2007 positions are contrasted below.

i. Pre-July 2007 Procedure

Debt agreements presented prior to the 2007 reforms were very simply processed. They required (a) the debtor to present a debt agreement proposal to the Official Receiver (b) the Official Receiver to ‘process’ it and then (c) creditors to decide whether to accept or reject it. In the normal course of events court involvement was not required. Processing simply involved the Official Receiver having creditors vote on the proposal. Creditors’ views could be expressed either by calling a meeting of those creditors known to the Official Receiver or by writing to such creditors to obtain their view on whether or not to accept it.29 In practice, the Official Receiver sought creditor views by post.

A debt agreement was accepted if a special resolution was passed in favour of the agreement. A ‘special resolution’ required at least 50 per cent in number and 75 per cent in value of creditors present personally, by telephone, by attorney or by proxy.30

ii. July 2007 Reforms

A somewhat more regulated regime applies to debt agreement proposals after 1 July 2007.31 A proposal is required to be accompanied by an explanatory statement in the approved form in which debtors must ‘state certain relevant information and . . . explain why they believe their proposal should be accepted’.32 Where a third party (that is, not the debtor) is to administer the proposal, then the administrator is also required to certify that:

(a) the debtor had received a copy of the prescribed information;33
(b) the administrator has reasonable grounds for believing that the debtor will be able to discharge their obligations under the agreement; and
(c) the administrator has reasonable grounds for believing that the debtor has set out the required information in their statement of affairs and explanatory statement.34

The debtor’s statement of affairs, which is lodged with the Official Receiver, is generally available for inspection by affected creditors.35

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29 Bankruptcy Act s 185B. The meeting, if held, is governed by provisions of the Act that apply to bankruptcy meetings: Bankruptcy Act s 185B(2).
30 Bankruptcy Act s 5(1).
31 Bankruptcy Legislation Amendment (Debt Agreements) Act 2007 Schedule 2 s 80.
32 Bankruptcy Act s 185C(2B) and Explanatory Memorandum, para 141.
33 See II above on the prescribed information that debtors must be given.
34 Bankruptcy Act s 185C(2D) and Explanatory Memorandum, para 142.
35 Bankruptcy Act s 185D(2)–(4).
Changes have been made to the ‘processing’ of a proposal by the Official Receiver. The debtor’s proposal must be lodged within 14 days of its signing. The Official Receiver may only accept a proposal for processing if the proposed administrator satisfies certain requirements. That is, the person is a registered administrator, a registered trustee or the administrator of five or fewer debt agreements, who has not been declared ineligible.

There is no longer an option of calling a creditors’ meeting. Creditors will be required to accept or reject a proposal using the approved form. They have ‘a right to inspect or obtain a copy of the approval or rejection forms of other creditors.’

Significantly, acceptance of a proposal now only requires an ordinary resolution, that is, a simple majority by value only. Provisions have been introduced on valuation of creditors’ claims, amongst other things to avoid manipulation of voting by entities related to the debtor who ‘buy’ debts.

The Official Receiver may cancel the processing of a proposal, for example where the debtor’s ‘statement of affairs or explanatory statement are materially inaccurate or materially misinform the creditors’.

### iii. Distinctive Features

There are a number of notable features in the Australian process. The first is the absence of court involvement. This contrasts, for example, with the United States Chapter 13 procedure. Under Chapter 13, it is the court which determines whether the plan is feasible and meets the Bankruptcy Code requirements.

Creditors may object to confirmation of the plan, for example on the grounds that they would receive more under a (Chapter 7) bankruptcy or that the debtor does not propose to contribute all of his or her income.

The second, related point is that the power to accept or reject a proposal lies with creditors. In the United States, as noted, this is a power exercised by the court. In the United Kingdom, the procedure under the Insolvency Act requires court approval. However the court’s role is limited in that it orders a creditors’ meeting and, if creditors approve (by 75 per cent majority in value), the court would generally approve the arrangement. The recent reforms largely do away with this, at least in relation to Debt Relief Orders.

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36 Bankruptcy Act s 185E(2AA).
37 Bankruptcy Act s 185E(2A)–(2C).
38 Bankruptcy Act s 185EA(1); 185EA(3); 185EB and Explanatory Memorandum, para 162.
39 Bankruptcy Act s 185EC(1)–(5).
40 Bankruptcy Act s 185ED and Explanatory Memorandum, paras 170–3.
41 US Bankruptcy Code ss 1324, 1325.
C. Flexibility of the Content

Until the 2007 reforms, the form and content of the debt agreement were not prescribed by the Act and so have allowed almost complete flexibility. One case is recorded of a debtor proposing to offer creditors a lottery ticket!

From 1 July 2007, a debt agreement proposal is required to be in an approved form. This has been introduced to encourage consistency and to assist creditors, many of whom must vote on many proposals a year, as well as debtors, who thereby must address all relevant issues.42

In addition, the proposal is required to provide that all provable debts rank equally; that creditors cannot receive more than 100 cents in the dollar; that the amount of a provable debt is ascertained at the time the original proposal is recorded on the National Personal Insolvency Index; and that secured creditor claims are to be limited to the unsecured portion of their claim. Debt agreements will not be able to provide for the transfer of non-monetary property to a creditor.43

Where an administrator is appointed, the proposed agreement is required to specify the administrator’s remuneration, a fixed percentage of the total amounts to be paid by the debtor. The fee may be taken from each payment over the life of the agreement44 and not in priority to creditors. These amendments were designed to remove financial incentives ‘which encourage administrators and their agents to focus on getting the debtor’s proposal accepted by creditors without proper regard to the debtor’s ability to afford the promised payments and awareness of all options available to them’.45

In comparison, the United States Chapter 13 provisions are more prescriptive. They require that a plan be between three and five years in duration, that (with some exceptions) priority creditors be paid in full46 and to some extent they regulate the amounts to be paid to secured and unsecured creditors.47

Provision is also made for a debt agreement to be varied. From July 2007, variation proposals are required to be in an approved form and to be accompanied by an explanatory statement.48 Creditors are also required to accept or reject a proposal using an approved form.49

42 Explanatory Memorandum, para 133.
43 Bankruptcy Act s 185C(2)(e–h); 185C(2A) and Explanatory Memorandum, paras 136–140.
44 Bankruptcy Act s 185C(3A).
45 Explanatory Memorandum, para 15.
46 See US Bankruptcy Code s 1322(a)(d).
47 See US Bankruptcy Code s 1325. If secured property is to be retained, the secured creditor must be paid at least the value of the security, in some cases the full amount owed. Unsecured creditors must receive at least as much as they would in a Chapter 7 bankruptcy.
48 Bankruptcy Act s 185M(1A)–(1C).
49 Bankruptcy Act s 185EA(3).
D. Administration

A notable feature of the Australian procedure is that the debt agreement need not be administered by an insolvency professional.\(^{50}\) This contrasts with the United States Chapter 13 requirements.\(^{51}\) Thus, in Australia, a debtor or a debtor’s family or friends, as well as commercial (fee-for-service) administrators, may administer a debt agreement. This was an attempt to minimise costs. However, debt agreement administration has proved to be a controversial aspect of the scheme. Even though there has not been a licensing system, since May 2003 the Inspector-General in Bankruptcy has had the power to declare an administrator ineligible for failing to perform their duties properly.\(^{52}\) More extensive regulation has been introduced with the 2007 reforms, as discussed below.

In the 2006 the number of active commercial Debt Agreement Administrators who charge a fee for service was 38 in the whole of Australia, 19 of whom were active in Queensland.\(^{53}\)

Some of the problems experienced with administration were explained in the Explanatory Memorandum accompanying the 2007 amendment bill:

Creditors have expressed a significant lack of confidence in the system which derives largely from their lack of confidence in debt agreement administrators who are involved in informing and advising debtors about their options as well as in administering the agreements once made. In particular, the concerns relate to the active promotion of debt agreements without proper consideration of other options, uncertainty about whether the debtor is making the best possible offer in the circumstances and the sustainability of offers made by many debtors. Administrators charge for setting up a debt agreement which provides a financial incentive to have the agreement accepted by creditors regardless of whether it is viable in the long term. Where the debt agreement fails, the debtor is usually in a worse financial position than at the start of the process.\(^{54}\)

A number of problems were identified with the existing approach of allowing anyone to be an administrator, unless they are declared to be ineligible. First, by delaying until there has been an investigation and declaration by the Inspector-General, considerable losses may have been suffered by debtors and creditors. Secondly, the approach did not address the pre-agreement activity undertaken by most administrators. Finally, the activities of a few incompetent administra-

\(^{50}\) Bankruptcy Act s 185C.
\(^{51}\) See US Bankruptcy Code s 102.
\(^{52}\) Explanatory Memorandum, para 10: ‘Since May 2003, there have been 10 administrators declared ineligible which is significant when there are only about 40 active administrators currently operating.’
\(^{54}\) House of Representatives, Bankruptcy Legislation Amendment (Debt Agreements) Bill 2007 Explanatory Memorandum, para 9.
tors were adversely affecting the reputation of reliable administrators as well as confidence in the system as a whole.\textsuperscript{55}

Consequently a new division on registration of debt agreement administrators has been introduced into the legislation. The key features of the new system are:

- an administrator who is administering more than five active debt agreements at any time will be required to be a registered debt agreement administrator;
- a registered administrator can be either an individual or a company;
- a person (including a company) who passes the basic eligibility test can apply for registration;
- registration will be on the basis of demonstrated ability to perform the duties of a debt agreement administrator;
- decisions on registration will be made by the Inspector-General in Bankruptcy;
- there will be fees payable for applying to become registered; and
- the Inspector-General will be able to cancel a person’s registration in certain circumstances.\textsuperscript{56}

E. Effects

A limited moratorium comes into place once a proposal has been accepted for processing. This moratorium lasts until the proposal is rejected by creditors or lapses on reaching the deadlines. During this time, enforcement of claims by creditors that would be provable in bankruptcy (other than claims under a maintenance agreement or order) is stayed.\textsuperscript{57} However, creditors can start or continue legal proceedings other than enforcement and this arguably includes a bankruptcy petition.\textsuperscript{58}

Once a debt agreement has been made, the debtor is released from all claims which would be provable in bankruptcy\textsuperscript{59} and there is a moratorium against creditors instituting or proceeding with a bankruptcy petition, other legal proceedings or enforcement processes (other than in relation to a maintenance

\textsuperscript{55} Explanatory Memorandum, para 14.
\textsuperscript{56} Explanatory Memorandum, para 50. The minimum education requirement will be a TAFE Certificate IV in Financial Services (specialising in accounting). As this minimal level will not address the insolvency knowledge requirement, it would be assessed by way of interview at the time of registration: Debt Agreement Amendments, FAQ February 2007, ITSA website.
\textsuperscript{57} Such claims are referred to as ‘frozen debts’: Bankruptcy Act s 185F. The s 185(1) definition of ‘frozen debt’ has been amended from July 2007 to align the class of creditors who can potentially be bound by an agreement and subject to the stay on proceedings once an agreement is established with those who are provided the opportunity to vote on a debt agreement proposal and who are prevented from enforcing their agreement during the processing of the proposal: Explanatory Memorandum para 126.
\textsuperscript{58} See Fraser v DCT (1996) 69 FCR 99 at 111; Re Jensen; ex parte Jensen (1982) 45 ALR 574; Re Hughes; ex parte Westpac Banking Corporation (unrep’d FC, Vic, 1324 of 1997, 28 November 1997).
\textsuperscript{59} Bankruptcy Act s 185J is replaced with s 185NA from July 2007.
agreement or order or proceeds of crime law). Unlike the United States Chapter 13, this does not release joint debtors or guarantors. Nor do the Australian provisions prevent secured creditors from realising their security. Australia has no homestead exemption in bankruptcy and there is no special provision in relation to this in the debt agreement process.

Another difference from the United States Chapter 13 procedure is that the Australian discharge provisions are the same as for bankruptcy. This is also the position taken in the United Kingdom Debt Relief Orders. In the United States, a Chapter 13 discharge is broader in some respects than for bankruptcy. Nor does Australia have an equivalent of the United States ‘hardship discharge’—where circumstances prevent the debtor from completing a Chapter 13 plan, discharge may still be available in limited circumstances. This provides an incentive for debtors to choose Chapter 13 over Chapter 7. Such an incentive does not exist under the Australian provisions. There are also fewer conditions attached to the discharge. For example, there is no requirement under the Australian provisions for court approval nor that the debtor completes an approved course in financial management.

The debt agreement is recorded on the National Personal Insolvency Index and will affect the debtor’s credit rating.

F. Relationship with Bankruptcy

Although Australia does not require (in contrast with the United States) that a debt agreement be only available if it will return to creditors at least as much as a bankruptcy, there remain a number of connections between the two processes. The first and most unfortunate is that a number of steps taken in the debt agreement process become grounds for the debtor’s bankruptcy. In particular, making a debt agreement proposal and acceptance of a proposal by creditors is an ‘act of bankruptcy’, the ground retained in Australia for bankruptcy. If the

60 Bankruptcy Act s 185K.
61 See US Bankruptcy Code ss 101(8) and 1301(a).
62 Bankruptcy Act s 185NA(3)
63 From July 2007, see Bankruptcy Act s 185XA.
64 Compare US Bankruptcy Code Chapter 13, in particular the ability debtors have in Chapter 13 to cure delinquent mortgage payments. See US Bankruptcy Code s 1322(c).
65 Bankruptcy Act s 185NA(1).
66 See Department for Constitutional Affairs, Tribunals, Court and Enforcement Bill: Detailed Policy Statement on Delegated Powers (December 2006), para 290.
67 US Bankruptcy Code s 1328(b).
68 In Chapter 13, debts obtained through false pretences, fraud or defalcation, fiduciary debts and debts for restitution or damages for willful or malicious acts that cause personal injury or death are discharged under Chapter 13 but not Chapter 7 (that is, unless creditors succeed in having them declared non-dischargeable). See US Bankruptcy Code ss 1328, 523(c).
69 Breach of a debt agreement and having a debt agreement terminated are also acts of bankruptcy. See Bankruptcy Act s 40(1)(ha), (hb), (hc) and (hd).
debt agreement process fails, the debtor will have provided grounds for a bankruptcy order to be made against them.

During the review of debt agreements undertaken by ITSA and the Commonwealth Attorney-General’s Department in 2005–2006, concerns were raised about allegedly misleading advertising undertaken by some administrators. For example, financial counsellors raised concerns about advertisements promoting debt agreements as a way of avoiding bankruptcy or preserving a debtor’s credit rating.70

Secondly, a debt agreement is automatically terminated if a debtor becomes bankrupt.71 Because the moratorium (see above) prevents a creditor’s petition against a debtor, the bankruptcy referred to here is a voluntary bankruptcy based on a debtor’s own petition or a bankruptcy where a petition has been presented against a partnership of which the debtor is a partner.

Finally, the termination of a debt agreement (discussed below), may provide grounds for the court to make a summary sequestration order and to order that the debtor be made bankrupt forthwith.72

G. Ending a debt agreement

In the ordinary course of events a debt agreement will end when it is completed.73 But provision is also made for terminating an agreement prematurely in certain circumstances. First, a debtor or a creditor may give the Official Receiver a written proposal to terminate an agreement.74 The Official Receiver processes this in the same way as a debt agreement proposal (discussed above). If accepted, the agreement is terminated.75 Secondly, where in effect a debtor has abandoned an agreement (committed a designated 6-month arrears default),76 there is an automatic termination.77 Thirdly, an agreement is terminated if the debtor becomes bankrupt. Fourthly, an application may be made to the court to have an agreement terminated. This application may be made by the debtor, a creditor or the Official Receiver. The grounds for such an order are

70 Review 2006, para 34.
71 Bankruptcy Act s 185R.
72 Bankruptcy Act ss 185Q, 185T.
73 Bankruptcy Act s 185N.
74 Bankruptcy Act s 185P. Detailed provisions on processing such proposals have been introduced through Bankruptcy Act ss 185PA–185PD.
75 Prior to July 2007, in limited circumstances, creditors could pass a special resolution to terminate a debt agreement if the debtor, after the agreement was entered into, has been subjected to a restraining order, forfeiture order or pecuniary penalty order made under proceeds of crime legislation: former Bankruptcy Act s 185QA.
76 That is, if a debtor has made no payments for a period of six months or has failed to complete the agreement within six months of the time specified in the agreement for its completion: Bankruptcy Act s 185(1) and the new s 185LC(3).
77 If the Official Receiver is satisfied that such a default has occurred, he or she must declare in writing that the agreement is terminated and record the termination on the National Personal Insolvency Index. Bankruptcy Act (newly amended) s 185QA.
that (a) the debtor failed to carry out the terms of the agreement, (b) implementing the agreement would cause injustice or undue delay to creditors or debtor, or (c) for ‘any other reason’ it should be terminated.\textsuperscript{78} It is at this point that the summary sequestration order, referred to under the previous heading, may be sought. Upon termination, the release of debts ceases and so creditors may restart debt collection processes.

There is also provision to have a debt agreement, or part of it, declared void.\textsuperscript{79} The application to this effect may be made by the debtor, a creditor or the Official Receiver. An order may be made where the court is satisfied that there is doubt over whether the debt agreement complies with the Act or where the statement of affairs is deficient in a material particular. A summary sequestration order may also be made.

\textit{i. Summary of features}

The Australian debt agreement scheme has been characterised by flexibility and minimal regulation. The entry requirements are nominal, the approval process and administration are informal and there are, in theory at least, limitless options in the type of arrangement that may be used. It is nevertheless also characterised as a creditor-dominated process, with creditors having the ultimate power to approve or reject the agreement.

In this sense the process is a mixed blessing for consumer debtors. It is no coincidence that the eligibility criteria for debt agreements were substantially eased in 2007 in an amending act, which was otherwise aimed at redressing perceived bias in favour of debtors in the bankruptcy system. Debt agreements were viewed by the creditor lobby as more likely to produce greater returns to creditors than bankruptcy would.

\section*{IV. EVIDENCE OF USE AND PRACTICAL ISSUES}

Since their introduction in December 1996, debt agreements have become increasingly popular among qualifying insolvent individuals.\textsuperscript{80} In the past 10 years, the number of agreements has grown rapidly each year to be more than 20 per cent of the number of bankruptcies. The annual rate of growth of debt agreements over the period has far exceeded that of bankruptcies. During this time, there has also been a significant reduction in the number of personal insolvency agreements.\textsuperscript{81}

\begin{itemize}
\item \textsuperscript{78} Bankruptcy Act s 185R; 185Q(4).
\item \textsuperscript{79} Bankruptcy Act s 185T.
\item \textsuperscript{80} For an earlier analysis, see D Beal, S Delpachitra, R Mason and D Troedson, ‘Which Consumer Debtors Decide to Enter a Part IX Agreement?’, (2004) 31 \textit{Australian Business Law Review} 7.
\item \textsuperscript{81} This may in part be related to the costs of entering a personal insolvency agreement, which are noted in the submission to the 2006 Review by the Business Law Committee of the Law Society of
\end{itemize}
Table 17.1 is derived from the Inspector-General’s Annual Report for 2005–2006 and provides a summary of personal insolvency activity under the Bankruptcy Act, broken down by the type of administration: Part IV Bankruptcies, Part XI Administration of Deceased Estates, Part IX Debt Agreements and Part X Personal Insolvency Agreements.82

Table 17.2 provides a comparison of the number of agreements in each state and territory with the relative population of those states. Interestingly, the proportion of the debt agreements is notably larger in the state of Queensland, which is the state with a significantly larger proportion of commercial Debt Agreement Administrators (some 50 per cent in 2004–2005) than other states.

The Explanatory Memorandum to the 2007 bill referred to the high failure rate of debt agreements: about ‘one-third are formally terminated and about one-third are not successfully completed but are not formally terminated’.83 Yet it is undisputed that the average rate of return for debt agreements is higher than for bankruptcy (only about 6 per cent of bankruptcies provide any dividend to creditors).84 Table 17.3 shows the average dividend rate in debt agreements during 2005–2006 to be 45 cents in the dollar. This table is based on information provided by debt agreement administrators through their annual returns lodged with ITSA.

<table>
<thead>
<tr>
<th>Financial year (1/7—30/6)</th>
<th>Bankruptcies (Parts IV and XI)</th>
<th>Debt agreements (Part IX)</th>
<th>Personal insolvency agreements (Part X)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1996–1997</td>
<td>21,846</td>
<td>47</td>
<td>439</td>
</tr>
<tr>
<td>1997–1998</td>
<td>24,408</td>
<td>369</td>
<td>427</td>
</tr>
<tr>
<td>1998–1999</td>
<td>26,378</td>
<td>480</td>
<td>492</td>
</tr>
<tr>
<td>1999–2000</td>
<td>23,373</td>
<td>802</td>
<td>406</td>
</tr>
<tr>
<td>2000–2001</td>
<td>23,902</td>
<td>1,223</td>
<td>409</td>
</tr>
<tr>
<td>2001–2002</td>
<td>24,114</td>
<td>3,258</td>
<td>313</td>
</tr>
<tr>
<td>2002–2003</td>
<td>22,639</td>
<td>4,445</td>
<td>251</td>
</tr>
<tr>
<td>2003–2004</td>
<td>20,497</td>
<td>5,382</td>
<td>175</td>
</tr>
<tr>
<td>2004–2005</td>
<td>20,501</td>
<td>4,739</td>
<td>158</td>
</tr>
</tbody>
</table>

NSW as being at least A$15,000, including administrator’s administration and outgoings such as advertising and filing fees.

83 Explanatory Memorandum, para 8.
84 Review 2006, para 66.
### Table 17.2 Debt Agreements Activity 2005–06 according to place of residence of Debtor\(^{85}\)

<table>
<thead>
<tr>
<th>Bankruptcy district</th>
<th>Debt agreements for 2005–06</th>
<th>Proportion of total debt agreements</th>
<th>Population at end of Sept quarter 2006</th>
<th>Proportion of population</th>
</tr>
</thead>
<tbody>
<tr>
<td>NSW</td>
<td>1,388</td>
<td>28.6%</td>
<td>6,844,200</td>
<td>33.1%</td>
</tr>
<tr>
<td>ACT</td>
<td>51</td>
<td>1.1%</td>
<td>329,500</td>
<td>1.6%</td>
</tr>
<tr>
<td>VIC</td>
<td>1,113</td>
<td>23%</td>
<td>5,110,500</td>
<td>24.7%</td>
</tr>
<tr>
<td>QLD</td>
<td>1,553</td>
<td>32%</td>
<td>4,070,400</td>
<td>19.7%</td>
</tr>
<tr>
<td>SA</td>
<td>220</td>
<td>4.5%</td>
<td>1,558,200</td>
<td>7.5%</td>
</tr>
<tr>
<td>NT</td>
<td>57</td>
<td>1.2%</td>
<td>207,700</td>
<td>1%</td>
</tr>
<tr>
<td>WA</td>
<td>317</td>
<td>6.5%</td>
<td>2,061,500</td>
<td>10%</td>
</tr>
<tr>
<td>TAS</td>
<td>149</td>
<td>3.1%</td>
<td>489,600</td>
<td>2.4%</td>
</tr>
<tr>
<td><strong>TOTAL</strong></td>
<td><strong>4,848</strong></td>
<td><strong>100%</strong></td>
<td><strong>20,671,600</strong></td>
<td><strong>100%</strong></td>
</tr>
</tbody>
</table>

### Table 17.3 Dividends in debt agreements completed during 2005–06\(^{87}\)

<table>
<thead>
<tr>
<th>Bankruptcy district</th>
<th>Agreements completed</th>
<th>Creditors’ claims $</th>
<th>Dividends paid $</th>
<th>Average dividend rate $</th>
</tr>
</thead>
<tbody>
<tr>
<td>NSW</td>
<td>769</td>
<td>11,730,496</td>
<td>6,392,721</td>
<td>0.54</td>
</tr>
<tr>
<td>ACT</td>
<td>456</td>
<td>6,604,833</td>
<td>2,142,648</td>
<td>0.32</td>
</tr>
<tr>
<td>VIC</td>
<td>24</td>
<td>370,087</td>
<td>144,765</td>
<td>0.39</td>
</tr>
<tr>
<td>QLD</td>
<td>464</td>
<td>6,847,058</td>
<td>2,612,884</td>
<td>0.38</td>
</tr>
<tr>
<td>SA</td>
<td>27</td>
<td>440,091</td>
<td>337,483</td>
<td>0.77</td>
</tr>
<tr>
<td>NT</td>
<td>73</td>
<td>139,414</td>
<td>411,161</td>
<td>0.36</td>
</tr>
<tr>
<td>WA</td>
<td>148</td>
<td>2,333,379</td>
<td>1,071,861</td>
<td>0.46</td>
</tr>
<tr>
<td>TAS</td>
<td>17</td>
<td>338,407</td>
<td>221,579</td>
<td>0.65</td>
</tr>
<tr>
<td><strong>TOTAL</strong></td>
<td><strong>1,978</strong></td>
<td><strong>29,803,764</strong></td>
<td><strong>13,335,402</strong></td>
<td><strong>0.45</strong></td>
</tr>
</tbody>
</table>

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\(^{86}\) Excludes Other Territories comprising Jervis Bay Territory, Christmas Island and the Cocos (Keeling) Islands.

\(^{87}\) *Annual Report by the Inspector General in Bankruptcy on the Operation of the Bankruptcy Act 2005–2006*, Commonwealth of Australia, Canberra, Table 25, page 34. ‘The dividend rate paid refers to the total amount paid to creditors over the period of the debt agreement for agreements that were completed and finalised in 2005–06. However, this does not take into account agreements that were terminated.’
The debtors’ perspective on debt agreements has twice been the subject of research by ITSA. In 2002, research was undertaken into the experience of debtors who proposed a debt agreement between August and October 2002, whether the debt agreement was successful or not. Positive findings included that 95 per cent of debtors surveyed indicated that ‘the debt agreement helped resolve their financial difficulty’; ‘even among those whose proposals were not accepted by creditors, 61 per cent said that it was worth trying’; and ‘more than 90 per cent affirmed that they had been able to maintain their repayments to creditors’. Further research initiated by ITSA in 2004 of debtors who were successful in achieving a debt agreement showed that 77 per cent of the debtors said that the debt agreement helped resolve their financial difficulties and the same percentage said that entering the debt agreement had made them better able to manage their household budget. An even higher percentage (83 per cent) rated the overall level of service provided by their administrator as acceptable or above average.

Areas of concern identified in 2002 included:

- the level of fees charged in some cases, especially ‘up front’ fees for preparing debt agreement proposals;
- 22 per cent of debtors whose proposals were accepted by creditors reported that creditors continued to approach them for payment;
- many debtors were advised to stop paying creditors when they lodged their debt agreement proposals, resulting in their financial situations deteriorating further if their proposals were not accepted by creditors;
- many debtors got advice from their administrator only, suggesting they may not have been aware of all options available; and
- fewer than one in six debtors sought help from financial counsellors.

In 2004, additional areas of concern included:

- 35 per cent of debtors said they were not informed that their name would be placed on a public register of insolvencies (although 76 per cent said the prescribed information, which includes this information, was explained to them);
- 19 per cent of debtors said they were not informed that their credit rating and ability to obtain further credit may be affected; and
- 69 per cent of debtors reported problems they had in being informed by their administrator about the progress of their agreement.

Additional issues relating to the effectiveness of debt agreements as a response to the state of insolvency were identified in the 2006 review. A major concern was the lack of information given to many debtors about all the options available.
(not such debt agreements). For example, creditors and financial counsellors were concerned that some debtors are not accessing other available options such as ‘hardship’ arrangements offered by many creditors. In respect of administrators’ fees, the concerns highlighted by the review included the lack of effective competition among debt agreement administrators; the priority for administrators’ fees meant creditors do not get paid, especially in the significant number of agreements which are terminated or not completed; and high set-up fees which are payable even if the debtor’s proposal is rejected by creditors.

Some of the debt agreement administrators concerns are that creditors:

- do not always record successful debt agreement status and continue to chase debtors for repayment;
- sell the debt without advising the purchaser of the debt agreement status so they continue to chase debts;
- demand high returns regardless of the debtor’s circumstances;
- decline the debtor’s best offer yet sell the debt for many less cents in the dollar;
- treat debt agreement administrators as if they were contracted debt collection agents working for them only;
- do not train their staff, such that debt agreement administrators continually use time and resources to do so.

V. THE REFORM PROCESS

ITSA has been active in undertaking analyses of debt agreements using material filed by debtors as well as surveys and consultations. In July 2000 they released an initial analysis based on debt agreement entered into between their introduction on 16 December 1996 and 31 May 2000. This was to assist with a review of the operation and effectiveness of debt agreements conducted during 2000–2001. This material contributed to the law reform process resulting in the 2003 amendments which

- increased by 50 per cent the statutory income limit for determining eligibility to make a debt agreement; and
- introduced a regulatory regime for debt agreement administrators which included the power for the Inspector-General in Bankruptcy to declare an administrator ineligible.

93 Review 2006, para 33.
95 Mumme, J, ‘A Reminder about what Debt Agreements are really about’, Presentation at the session on Dealing with Debt: Making debt agreements more effective, Sixth ITSA Bankruptcy Congress, Brisbane, July 2006, slide 6.
96 Review 2006, para 15.
Then, in August 2005, the Attorney-General asked ITSA and the Attorney-General’s Department to conduct another review of the operation of debt agreements. Submissions were sought from the public and discussions were held with key stakeholders. The Attorney-General specifically asked that the report comment on whether:

- debt agreements are accessible to debtors as a viable alternative to other forms of personal insolvency administration;
- debt agreements improve the returns that would otherwise be available to creditors;
- debt agreements provide a mechanism for the fair and efficient distribution of a debtor’s resources among unsecured creditors;
- debt agreement administrators provide appropriate accountability towards debtors and creditors; and
- the Inspector-General in Bankruptcy, Official Receiver and Official Trustee play an appropriate role in regulating, and promoting best practice, efficiency and competition, in relation to debt agreements.

In March 2006 following release of the report, the Attorney-General announced proposed reforms to the debt agreements procedure.97 Then, in July 2006, more details on the reforms were released, taking into account comments received following the earlier announcement. There followed a further period of consultation by ITSA through forums held with debt agreement administrators and separately with creditors. Discussion papers were also released on the debt agreement reforms.

VI. CONCLUSION

This close working by ITSA with the relevant stakeholders in relation to debt agreements to identify not only potential law reforms but also practical matters that can improve their operations is to be commended. It is noteworthy that Jan Pentland, financial counsellor and former President of AFCCRA (Australian Financial Counselling & Credit Reform Association) stated in a paper presented at the biennial ITSA Congress in 2006, ‘In general AFCCRA and financial counsellors across Australia agreed with the proposals arising from the [2006] review. We appreciated ITSA’s work on what we saw as a very thorough process with appropriate outcomes.’98

Also to be commended is the amount of empirical research being undertaken to contribute to the law reform deliberations. This material has been released on

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97 Attorney-General, Government to Overhaul Bankruptcy Debt Agreements (Media Release 46 of 2006).
the ITSA website and includes not only the analyses of material filed with debt agreements\(^99\) but also stakeholder inputs through submissions and forums.

It is within this context that some themes underpinning the regulation of debt agreements since their introduction should be considered. One substantial theme has been the attempt to offer consumer debtors an informal and thus less costly alternative to bankruptcy. Yet over time, the amount of regulation has increased. The initial legislation comprised some 27 sections that have now more than doubled in number as well as been supplemented by approved forms, bankruptcy regulations and guidelines.

Unscrupulous fee-for-service administrators have had an impact on creditor and general confidence in the system. This has led to the establishment of a registration regime (with accompanying registration fees)—even though an interim approach of minimal regulation by declaring certain administrators ineligible was first adopted.

Yet the overall message of the debt agreement process has been that it is a success story, as measured by the number being taken up and the average dividends being realised for creditors. This seems to vindicate the reasons for introducing alternatives to bankruptcy for low income, low asset/liability debtors in that debt agreements have successfully provided an alternative regime to better promote debtor rehabilitation and to offer greater returns to creditors while avoiding the excessive consequence of bankruptcy.

THE TERM ‘PERSONAL BANKRUPTCY’ is no longer foreign in Korea. Advertisements on personal bankruptcy proceedings can be easily noticed in public transportations. It is a significant change in a society where bankruptcy has been regarded in a very negative way. The number of personal bankruptcy cases\(^1\) has continually increased, as can be seen in Table 18.1, and is expected to increase for a while.

The number of credit defaulters soared as illustrated in Table 18.2, reaching almost 4 million, 8 per cent of the total population, because of the financial

<table>
<thead>
<tr>
<th></th>
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<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Bankruptcy</td>
<td>350</td>
<td>505</td>
<td>329</td>
<td>672</td>
<td>1,335</td>
<td>3,856</td>
<td>12,317</td>
<td>38,773</td>
<td>123,691</td>
</tr>
<tr>
<td>Rehabilitation</td>
<td>n/a</td>
<td>n/a</td>
<td>n/a</td>
<td>n/a</td>
<td>n/a</td>
<td>n/a</td>
<td>9,070</td>
<td>48,541</td>
<td>56,155</td>
</tr>
<tr>
<td>Workouts(*)**</td>
<td>n/a</td>
<td>n/a</td>
<td>n/a</td>
<td>n/a</td>
<td>505</td>
<td>62,550</td>
<td>287,352</td>
<td>193,698</td>
<td>85,826</td>
</tr>
</tbody>
</table>

\(\star\) Number of cases filed in respective years.
\(\star\)* Applications were accepted from 1 November 2002.

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\(^{1}\) Personal bankruptcy cases can be handled in three ways: court proceedings, out-of-court proceedings and non-proceeding, which means doing nothing. Court proceedings include the bankruptcy proceeding and the individual rehabilitation proceeding. Out-of-court proceedings consist of the individual workout, the bad bank program (in 2004 and 2005, bad banks purchased nonperforming loans against personal debtors, extended due dates up to eight years and reduced the amount of interest), individual or collective debt rescheduling by creditor financial institutions, and a debt rescheduling and support program for low-income credit delinquents. The last three programs ran for a short period of time while the workout program is still effective. For detailed information, see S Oh, ‘Personal Bankruptcy in Korea: Challenges and Responses’ (2006) 7 *Theoretical Inquiries in Law* 597.
crisis in the late 1990s\textsuperscript{2} and excessive and irresponsible issuance of credit cards in the early 2000s. Individual debtors could seek relief by liquidation through the bankruptcy proceedings, governed by the Bankruptcy Act. However, proceedings aiming to rehabilitate did not exist until the individual workout program and the rehabilitation proceeding were introduced.

The individual workout\textsuperscript{3} was introduced in 2002 to resolve the problems with credit defaulters. Because financial institutions were reluctant to reschedule nonperforming loans of individual debtors, the government pushed them to accept a structured workout program. In the past, reduction of debts by financial creditor institutions was considered as highly unscrupulous behavior.

### Table 18.2 Trend of indebtedness

<table>
<thead>
<tr>
<th>Year</th>
<th>Budo\textsuperscript{*}</th>
<th>Household credit\textsuperscript{**}</th>
<th>Credit defaulters\textsuperscript{***}</th>
</tr>
</thead>
<tbody>
<tr>
<td>1997</td>
<td>17,168</td>
<td>211,166</td>
<td>n/a</td>
</tr>
<tr>
<td>1998</td>
<td>22,828</td>
<td>183,648</td>
<td>n/a</td>
</tr>
<tr>
<td>1999</td>
<td>6,718</td>
<td>214,036</td>
<td>1,995,952</td>
</tr>
<tr>
<td>2000</td>
<td>6,693</td>
<td>266,899</td>
<td>2,084,017</td>
</tr>
<tr>
<td>2001</td>
<td>5,277</td>
<td>341,673</td>
<td>2,450,303</td>
</tr>
<tr>
<td>2002</td>
<td>4,244</td>
<td>439,060</td>
<td>2,635,723</td>
</tr>
<tr>
<td>2003</td>
<td>5,308</td>
<td>447,568</td>
<td>3,720,031</td>
</tr>
<tr>
<td>2004</td>
<td>4,445</td>
<td>474,662</td>
<td>3,615,367</td>
</tr>
<tr>
<td>2005</td>
<td>3,416</td>
<td>521,495</td>
<td>(est) 3,224,000</td>
</tr>
<tr>
<td>2006</td>
<td>2,529</td>
<td>581,963</td>
<td>(est) 2,870,000</td>
</tr>
</tbody>
</table>

\textsuperscript{*}Budo: Rebounded checks or notes, which means failure of business firms.

\textsuperscript{**}Family debts: (unit: billion KRW)

\textsuperscript{***}Credit defaulters: debtors with unpaid debts of at least KRW 300,000\textsuperscript{4} for over three months.\textsuperscript{5}

\textsuperscript{2} On 28 November 1997 the Korean government received a rescue loan from the International Monetary Fund (IMF) to restore its level of foreign currency reserves. During the restructuring processes following the bailout, about 15 per cent of listed companies went into bankruptcy and 28.8 per cent of financial institutions were closed down.

\textsuperscript{3} The official term for the individual workout is the Support Program for Credit Recovery. The term ‘workout’ has been used since its establishment because it was modeled after the workout program for business corporations based on the Agreement for the Corporate Restructuring among Creditor Financial Institutions signed by 210 domestic financial institutions on 28 June 1998.

\textsuperscript{4} US$1 was equivalent to around 940 Korean won in June 2007.

\textsuperscript{5} People labeled as a ‘credit delinquent’ faced various forms of social discrimination. The term was abolished when the Utilization and Protection of Credit Information Act (UPCIA) was amended on 28 April 2005. Now debtors who fail to pay debts over KRW 300,000 for over three months are registered by financial institutions at the KFB (Korea Federation of Banks). There is no official category to classify them and no term to name those debtors whose default information is registered or shared but they are known in practice as ‘financial debt defaulters’ because their nonpayment information can be found under the category of ‘Information of Debt Default.’ The Government did not officially announce the number of financial debt defaulters after the amendment to UPCIA. In this paper, ‘credit defaulter’ includes, but is not limited to, ‘financial debt defaulters.’
reduction or debt-for-equity swapping was first adopted in 1998 as a debt arrangement of ailing companies, but only later was it applied to individual debtors. Similarly, although the Bankruptcy Act had been in force since 1962, it was not until 2001 that an overindebted debtor was discharged in a personal bankruptcy proceeding. The only way to reschedule debt was extending a due date or providing revolving loans.

The Financial Supervisory Service (FSS), a governmental agency in charge of the supervision of financial institutions, established the Credit Counseling and Recovery Service (CCRS), a consortium of over 3,000 financial institutions, in October 2002 to implement a workout program. In addition to debt rescheduling, CCRS helps people to repay their debt, to find a suitable job and receive free education in order to restore their financial status.\(^6\)

The rehabilitation proceeding, modeled after the Chapter 11 proceeding of the US Bankruptcy Code, was first established in 2004, under the Individual Debtor Rehabilitation Act.\(^7\) Later the Individual Debtor Rehabilitation Act was merged into the Debtor Rehabilitation and Bankruptcy Act of 2005.

Until recently, information on personal bankruptcy has been limited in Korea. Nowadays the CCRS makes monthly activities reports to the press. The Accord on Support for Credit Recovery, which contains rules on debt rescheduling, is publicly available. However, details of the workout program remain vague; workout applicants’ social and economic status, contents of debt rescheduling, and its final effect on individual lives are still indefinite.

As for judicial proceedings, the KDI\(^8\) conducted empirical research to analyze 672 individual rehabilitation cases from January to March 2005 and it studied 1,016 bankruptcy cases rendering discharge in 2004. The research was based on court-provided data and it dealt with detailed and reliable information. However, one can enrich comparison between the individual rehabilitation proceeding and the bankruptcy proceeding, which are judicial schemes, by also comparing the individual rehabilitation proceeding and the individual workout, which are both rehabilitation schemes (Table 18.3).

Table 18.3 Personal bankruptcy proceedings in Korea

<table>
<thead>
<tr>
<th></th>
<th>Rehabilitation</th>
<th>Liquidation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Judicial proceeding</td>
<td>Individual rehabilitation</td>
<td>Bankruptcy</td>
</tr>
<tr>
<td>Non-judicial proceeding</td>
<td>Individual workout</td>
<td>—</td>
</tr>
</tbody>
</table>

\(^6\) <http://english.ccrs.or.kr/>.

\(^7\) Originally the rehabilitation proceeding was a part of the bill of insolvency law prepared by the Government and sent to the National Assembly in 2003. As the enactment of the bill was delayed, the National Assembly separately enacted Individual Debtor Rehabilitation Act in 2004. The new insolvency law (Debtor Rehabilitation and Bankruptcy Act), which was passed in 2005, merged the Individual Debtor Rehabilitation Act into it after a few amendments.

\(^8\) Korea Development Institute, an economic think tank on the function of individual bankruptcy and rehabilitation, November 2005 (in Korean).
This Chapter has two purposes. One is to look into the socio-financial status of applicants for a form of rehabilitation proceeding (called rehabilitation and workout) and into how their debts are rescheduled in the two proceedings. This Chapter, however, does not deal with the effects of these programs; that is, whether and how individual debtors’ lives are improved and whether or not repayment plans are carried out appropriately. The other purpose is to verify whether debtors recognize the difference between applying for the rehabilitation proceeding and the workout program. If I can discover differences in practice that are best explained as reflecting a distinction between rules governing the two proceedings, I would have evidence about which points are important in personal bankruptcy rules.

For this study, approximately 1,000 cases of individual rehabilitation proceedings and individual workouts were collected. The data on individual rehabilitation proceeding was collected from application forms submitted to the court from 2004 to 2006. The data on individual workout was collected from the draft rescheduling plan submitted to the Deliberation Committee of CCRS in 2006.

II STRUCTURES AND RULES OF THE TWO PROCEEDINGS

A. Individual Workout Program

The individual workout program (hereinafter ‘workout’) is based on an agreement worked out by participating financial institutions. While participating financial institutions are bound to the finalized workout plan, nonparticipating creditors are not affected by the workout program. Rescheduling and discharge of debts through the workout is executed based on the terms of agreement.

Applicants are required (a) to be registered as debtors in arrears with payment at Korea Federation of Banks (KFB), (b) to have an income sufficient to cover the cost of living and repay a minimum portion of debts against participating financial institutions and (c) to owe less than 500 million won to two or more financial institutions.

If debt repayments to a financial institution are overdue for over three months, the financial institution notifies the KFB. The KFB will then register the debtor as a debtor in arrears with payment to financial institutions (‘a debtor in arrears’). Because information on debtors in arrears is available to financial institutions, a debtor in arrears will meet difficulties using financial services including borrowing money in the future.

9 Though the entry and exit to the Accord is open, the number of participating financial institutions has not changed much. Most financial institutions are parties to the program. As at 30 June 2007, participating financial institutions included 19 commercial banks, 24 insurance companies, nine credit card companies, 14 installment finance companies, nine lease companies, 109 saving banks, five asset management companies, 24 guarantee companies, 1,247 agricultural cooperative unions, 90 fishery cooperation unions, 1,096 community saving and loans, 132 forest unions, 566 credit unions, and 262 bankruptcy estates (bankrupt entities of former financial institutions).
While the source of income is not restricted in the workout program (thus it includes income from part-time jobs, pension, social security support and even financial support from a third party), the amount is what matters; whether or not it is sufficient to cover the minimum amount of repayment required. Since the Accord allows debts to be reduced only to a certain level, the income of a debtor should be high enough to repay the unreduced portion of debts. If not, it is impossible to prepare a workout plan, meaning a debtor is unable to benefit from the workout program.

Debt reduction (including principal and interest) is possible if the value of the debtor’s property is insufficient to repay the entire debt and the total amount of debt to be paid according to the workout exceeds the amount collectable by compulsory execution. The Accord stipulates rules on reduction of debts in Art 11, para 1, subpara 5; (a) total debts can be reduced up to one third of the total amount, (b) interest can be reduced over one third of the total interest owing, (c) the principal of claims can be reduced, up to 30–50 per cent, in case of claims written off by the creditor financial institutions. Debts secured by a home mortgage can be included in the workout.

The workout program begins when a debtor consults an advisor of the CCRS. If the qualification of a debtor is confirmed, the debtor pays 50,000 won for the application fee. The CCRS requests financial institutions to file their claims to the CCRS with information on the total amount of debt (including written-off claims), collaterals, guarantees, and their opinion on the application of the workout to the debtor. The advisor prepares a rescheduling plan based on the application form submitted by the debtor and the debt information filed by financial institutions. The advisor also listens to the opinion of the debtor and creditors and adjusts the plan if necessary. The workout plan is then submitted to the Deliberation Committee for review and approval. After the approval, the workout plan is sent to the creditors’ financial institutions for consent. Within 10 days, the creditors’ financial institution must give the CCRS notification concerning their consent. To be finalized, the workout plan has to be approved by holders of over half of the claims. Repayments are made by the debtor but the CCRS strongly advises the debtor to deposit a monthly payment into a bank account and have it automatically transferred to creditors.

If a workout plan does not receive the consent of the creditors, the workout plan is reviewed again and, if necessary, adjusted by the Deliberation Committee and resent to the discontenting creditors for consent. As the consent of the majority of creditors is required to finalize the plan, this procedure may be repeated until the consent of the creditors is gained.

When repayment is completed pursuant to a workout plan, the debtor is discharged from the reduced portion of debt, as well as any interest accrued after the finalization of the plan. If the debtor fails to repay for more than three months in a row, rescheduling according to the plan is canceled and participating creditor financial institutions may resort to compulsory execution under general collection laws.
B. Individual Rehabilitation Proceeding

The aim of the individual rehabilitation proceeding is to restore overindebted individuals. The proceeding begins by the application of a debtor and ends by a decision of discharge by the court. Most procedures consist of interaction between the court and the individual debtor. The creditor, however, has a chance to participate in the proceeding by stating an objection against the repayment plan.

Individuals who satisfy the following requirements are eligible for the application of the individual rehabilitation proceeding. The individual has a cause for bankruptcy, has wage income or business income or possibility to earn such an income in the future, has liabilities of less than one billion won in secured debts and five hundred million won in unsecured debts and has disposable income.

Disposable income is a key concept in the individual rehabilitation proceeding. It is a requirement not only for application but also for the confirmation of a payment plan by the court in cases where an objection is stated. Disposable income is calculated by deducting from the total amount of income (a) taxes and social insurance premiums, (b) living expenses for the maintenance of the debtor and his dependants and (c) business expenses in case of the self-employed. Living expenses in practice refer to 150 per cent of the minimum living expenses set by the government in accordance with the National Basic Living Security Protection Act.

The applicant should submit an application form, the schedule of property, the schedule of creditors and the schedule of income and expenses. The schedule of creditors should be divided into unsecured creditors and secured creditors. Secured creditors are those whose claims are secured by collateral including mortgage and pledge. A claim guaranteed by an individual or a legal person is not a secured claim. Secured claims are admitted to the extent of the value of collateral. The remaining amount owed to secured creditors are recognized as unsecured claims. The value of collateral is estimated at its liquidation value.

The debts of an applicant are recognized through the schedule of creditors prepared by the debtor. There is no filing of claims by creditors. Upon the decision of commencement, every creditor including the secured creditors cannot exercise their claims until a repayment plan is confirmed. It is noteworthy that only listed claims are subject to the stay. Creditors who have unlisted claims may exercise their rights of enforcement even after the commencement of the individual rehabilitation proceeding. Debts not listed in the schedule of creditors are not subject to rearrangement of the individual rehabilitation proceeding.

Though there is no procedure of filing claims, anybody may lodge an appeal against the contents in the schedule of creditors. For example, if a claim is omitted or falsely listed in the schedule, the said creditor or other creditors may apply for the judgment.
The repayment plan is usually submitted upon application or within 14 days from the date of application. It shows how the disposable income will be distributed to the creditors during a certain period of time. Future income is estimated by the average income of the past year. Changes in disposable income during the period of repayment (three to five years) can be made due to changes in the amount of income or the number of dependants or unexpected living expenses. In principle, however, disposable income is calculated on the basis of the situation at the date of commencement. The repayment period of the plan is three years at minimum and five years at maximum depending on the amount of debts and income. If the disposable income cannot cover the debts in spite of five years’ repayment, the remaining portion is to be left unpaid. If the principal of the debt can be repaid in less than three years, the interest should be paid up to three years. The interest which cannot be paid within three years does not have to be paid. In sum, during the first three years, the principal debt and, when possible, interest should be paid, during the fourth to fifth year principal only, and after fifth year no repayment at all.

There is no voting on the repayment plan by creditors, but a creditor can raise an objection against the repayment plan. When no objection is raised, the court shall confirm the repayment plan if (a) the plan complies with the relevant laws and regulations, (b) the plan is fair, equitable and feasible, (c) all expenses, commissions and other amounts payable have been paid before confirmation of the repayment plan and (d) the total repayment amount of individual rehabilitation claims is not less than the total amount that is distributable in case of the debtor’s bankruptcy. The best interest of creditors test applies to the gross amount of repayment (not repayment amount to individual creditors) in the procedure of the confirmation.

If there is an objection by a creditor, three items are added to the requirements for the confirmation without objection. First, the best interest of creditors test applies to an individual creditor invoking an objection. Second, disposable income should be used for the repayment. Third, the present value of repayment should not be less than the certain amounts as DRBA stipulates. The requirement of minimum repayment was added to ease the criticisms concerning the misuse of the pro-debtor individual rehabilitation proceeding. The court may order the debtor to amend the repayment plan.

10 DRBA, Art 614, para 2, subpara 3.

The total amount of repayment to individual rehabilitation claims, as evaluated on the date of the decision to confirm the repayment plan, shall not be more than KRW 30,000,000 and not less than the amounts set out in the following items:

a. In cases in which the total amount of individual rehabilitation claims as evaluated on the date of the decision to confirm the repayment plan is less than KRW 50,000,000, 5 per cent of the total amount.

b. In cases in which the total amount of individual rehabilitation claims as evaluated on the date of the decision to confirm the repayment plan is not less than KRW 50,000,000, 3 per cent of the total amount plus KRW 1,000,000.
When the court confirms the repayment plan, unsecured creditors can be repaid pursuant to the plan. As long as the repayment plan is properly implemented, unsecured creditors cannot exercise their claims in their original amount and conditions. Secured creditors, however, can exercise their claims because the repayment plan does not bind the secured creditors. If debts are not repaid as the repayment plan prescribed, a creditor may petition for the discontinuation of the individual rehabilitation proceeding. When the proceeding is discontinued, payments already made are valid, but a creditor may exercise their claims of their original amount minus the repaid amount.

If the repayment plan is implemented successfully, the court may decide to discharge the debtor from the remaining debts after completion of the repayment plan. In addition, DRBA adopts ‘hardship discharge.’ Even if the repayment plan is not fully implemented, the court may grant discharge if (a) the debtor fails to complete repayment due to a reason beyond the control of the debtor, (b) the amount repaid to the individual rehabilitation creditors by the date when a discharge is decided is not less than the amount that would have been distributed to the creditors from a bankruptcy proceeding, and (c) amendment to the repayment plan is not possible. However, in cases of normal as well as hardship discharge the court may decide to disapprove discharge if (a) there is any claim that the debtor has not declared in bad faith in the schedule of creditors or (b) the debtor has not performed the obligations of the debtor as stipulated in DRBA, such as an arbitrary repayment to a creditor in a manner which is not as stipulated in the repayment plan.

When discharged, the debtor is free from the liability of unpaid debts except (a) claims not entered in the schedule of creditors, (b) tax claims, (c) fines and penalties, (d) compensation for damage for torts conducted by the debtor in bad faith, (e) compensation for damage for torts harming the life or body of another person by grave negligence, (f) wages, severance pay and disaster compensation for the employees of the debtor, (g) deposit money for the employees and guarantee money for the employee’s personal liability and (h) expenses from maintenance and alimony. As the discharge does not protect those who provide guarantee or collateral for the debtor, creditors may exercise their claims against them even after the discharge.

C. Comparison between Workout and Rehabilitation

The differences between two programs are summarized in Table 18.4.
III. APPLICANTS

A. Demographic Information

i. Gender, Marriage and Age

Over half of applicants, 57.92 per cent for the workout and 56.39 per cent for the rehabilitation, were male. Gender does not appear to be a significant factor in deciding whether to use the personal bankruptcy proceeding, the workout or the rehabilitation proceeding.

Marital status, however, showed a difference in the workout and the rehabilitation samples. Unmarried applicants amounted to 26.48 per cent of the

<table>
<thead>
<tr>
<th>Table 18.4 Comparison of workout and rehabilitation</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Workout</strong></td>
</tr>
<tr>
<td>Legal ground</td>
</tr>
<tr>
<td>Managing body</td>
</tr>
<tr>
<td>Maximum debt</td>
</tr>
<tr>
<td>Creditors subjected</td>
</tr>
<tr>
<td>Secured claims</td>
</tr>
<tr>
<td>Period of repayment</td>
</tr>
<tr>
<td>Deduction of principal</td>
</tr>
<tr>
<td></td>
</tr>
<tr>
<td></td>
</tr>
<tr>
<td>Deduction of interest</td>
</tr>
<tr>
<td>Guarantor</td>
</tr>
<tr>
<td>Discharge</td>
</tr>
<tr>
<td></td>
</tr>
<tr>
<td>Reapplication</td>
</tr>
</tbody>
</table>
rehabilitation sample but only 10.28 per cent of the workout sample. It might imply that younger debtors choose rehabilitation more frequently as they are less reluctant to use judicial proceedings. Divorce rates in both programs (11.63 per cent in the workout and 9.3 per cent in the rehabilitation) are higher than the average nationwide divorce rate of 4.7 per cent. Bad financial situations might be a cause of divorce.

Graph 18.1 shows the number of applicants for the workout program and the rehabilitation proceeding by age as compared to the economically productive population (‘EPP’). Table 18.5 explains the reason for different age pattern; about 40 per cent of credit defaulters were in their thirties (30.56 per cent for workout and 51.55 per cent for rehabilitation). The number of applicants for both programs seems to be proportionate to the number of credit defaulters by age. However, different generations chose different programs. Younger applicants showed a tendency to choose the rehabilitation proceeding. Possibly it shows that the younger generation is less reluctant to use judicial proceedings than the older generation, a tendency which is also supported by several other research results. Younger debtors might have other reasons for preferring rehabilitation, such as the more favorable treatment of some types of debts in the rehabilitation proceeding or its shorter repayment period.

![Graph 18.1 Applicant by age](image)

Table 18.5 Number of credit defaulters by age

<table>
<thead>
<tr>
<th>Ages</th>
<th>Under 19</th>
<th>20–29</th>
<th>30–39</th>
<th>Over 40</th>
</tr>
</thead>
<tbody>
<tr>
<td>Number</td>
<td>1,994</td>
<td>639,434</td>
<td>1,439,206</td>
<td>1,544,733</td>
</tr>
<tr>
<td>Ratio (%)</td>
<td>0.06</td>
<td>17.68</td>
<td>39.81</td>
<td>42.45</td>
</tr>
</tbody>
</table>

* As of 31 December 2004
ii. Education

Korea has a mandatory education system from elementary school to junior high school, which takes nine years. The average period of education in 2001 was 11.6 years at the national level.\(^{11}\) Applicants for the workout or the rehabilitation were more educated than the average citizen. If we do not assume that more educated are more overindebted, Graph 18.3 shows that more educated people utilize judicial and social programs more frequently than less educated people.

Graph 18.3 also reveals that applicants for the rehabilitation had received higher education than those for the workout. Two assumptions are possible; one is that the highly educated tend to be less anti-judicial and another is that they are aware of the advantages of the rehabilitation procedure. Highly educated people might feel less resistant in using judicial proceedings. They might not consider the retainer fee for lawyers as a waste. They might want a more rapid and comprehensive resolution for their overindebtedness. The rehabilitation is more favorable to debtors whose debts are not secured and not guaranteed by friends or family members. The rehabilitation plan covers claims of non-participating creditors. Moreover, applicants can be discharged after five years. Educated debtors seemed to distinguish the difference between the two programs.

iii. Housing

Applicants owning their housing amounted to about 22 per cent in the workout and 7 per cent in the rehabilitation.\(^{12}\) It reflects the different rules of the two pro-

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\(^{11}\) Average period of education = total years of education / (total population over six years old—population of students).

\(^{12}\) According to the 2000 housing census, 70.58 per cent among 10,959,342 households lived in their own housing, 26.63 per cent in leased and 2.77 per cent in free housing.
grams. The workout program usually allows a debtor to keep his or her residence by letting secured claims over the residence house to be repaid as originally scheduled. In the rehabilitation proceeding, however, mortgage holders are not subject to the proceeding and can foreclose the collateral if the payment is not made. So an applicant for rehabilitation needs to obtain consent of the mortgage holder to keep the housing.

Free rent, which amounted to almost 50 per cent in both programs, was provided by family members including spouse, parents, brothers and sisters in most cases. It indicates that the social safety net of Korea is still family based. That is the reason why the number of homeless is relatively small in Korea in spite of her weak social safety net. In case of rent, about 82 per cent of rehabilitation applicants and 74 per cent of workout applicants used rent without deposit. In the rent market of Korea, rent without deposit is usually limited to poorer residences.

**Graph 18.3 Housing**

**Graph 18.4 Provider of free housing**
B. Financial Status

i. Properties

About 60 per cent of applicants had properties worth less than 10 million won in both the workout and the rehabilitation. In the workout, the median was 5 million won whereas the mean was 28.5 million won. In the rehabilitation proceedings, the mean amount of properties was 14.7 million won and the median was 4.8 million won. Half of the applicants for the two programs had less than 5 million won.

About 31 per cent of applicants for the workout owned real estate properties, most of which was housing, whereas only 11 per cent of applicants for the rehabilitation owned real estate. The value of real estate properties differed; the mean was 74.3 million won in the workout and 20.9 million won in the rehabilitation, and the median was 60 million won in the workout and 14.3 million won in the rehabilitation. Because real estate properties are not protected effectively in the rehabilitation proceeding, as we have seen in the previous section, debtors owning real estate tended to choose the workout instead of the rehabilitation. The workout plan usually allowed the applicant to maintain real estate properties used for residence even though it was mortgaged. Under a rehabilitation plan, however, mortgaged properties are hard to retain because secured creditors are not subject to the rehabilitation plan.

ii. Debts

An application form for a workout shows four types of debts; unsecured debts (45.17 per cent), secured debts (1.8 per cent), debts with personal guarantor (46.6 per cent), and debts of guarantee (0.8 per cent). Applicants for the workout used personal guarantors much more frequently than collateral for security; presumably they did not have such collaterals.

Graph 18.5 Properties
Even though the rehabilitation proceeding does not bind secured claims, the amount of secured debts are required to be filled out in the application form and 16.97 per cent of rehabilitation applicants had secured debts. The average amount of secured debts was 3.62 million won. The ratio of secured debts to total debts spread from 0.73 per cent to 7.84 per cent. The ratio tended to increase as the total amount of debts increased.

The average amount of unsecured debts was 117.8 million won in the rehabilitation proceeding and 73.55 million won in the workout. One possible explanation for this difference is the amount of debts against non-participating creditors. Because the workout applies to participating financial institutions only, debtors with debts to moneylenders, who are the main source of financing to debtors with low credit ranking, lack incentive to apply for the workout.

It has been possible to obtain only limited information about the causes of overindebtedness. The potential causes of overindebtedness can be divided into two categories; decrease of income or property, and increase of expense or liability. For instance, unemployment, wage decrease, business or investment failure and failure in money transaction can cause the decrease of income or property. In line with that, excessive hospital expense and guarantee liability can bring about increase of expense or liability. Application forms of both programs have check-in boxes under the title of cause of delinquency. The boxes, however, are not divided into useful categories. Many applicants seemed to be confused with the meaning of each box and mark the box of living expenses because they spent most of their money on food and housing. In most cases where the box of living expenses was marked, the real reason for overindebtedness would be a decrease of income. Moreover, as several boxes could be chosen by an applicant, each answer had different weight. Though Table 18.6 had such problems, it provides some useful information on the issue.

In the workout, half of applicants cited ‘business failure’ as the cause of failure. Only about 25 per cent of the workout respondents were self-employed at the time of application, however. In the rehabilitation proceedings, about 30 per cent of applicants were bankrupt due to business, but only 7 per cent were still self-employed at the time of the proceeding. It is not clear why fewer rehabilitation applicants run a business during the proceeding as compared to the workout applicants. One possible answer could be that rehabilitation applicants were more qualified to be employed than the workout applicants.

In Korea money transactions and guarantees were usually made between friends, relatives and colleagues. Over 30 per cent of applicants suffered from loss of money and human relationship at the same time. Hospital expenses accounted for about 15 per cent of the reasons. Even though Korea is said to maintain a healthy public health insurance system, serious illness can financially ruin a family. One notable feature in Table 18.6 is the fact that 24 per cent of

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13 It was reported that average debt per capita at the end of 2006 was estimated as 14,000,000 won.
rehabilitation applicants pick ‘guarantee liability’ as the cause of overindebtedness whereas only 6 per cent in the workout do so.

iii. Income

Applicants for the workout were divided into four categories depending on their source of income: wage earners (42.8 per cent); part-timers (31.56 per cent); pensioners or support recipients (0.82 per cent); and the self-employed (25.54 per cent). The average income of each category was as follows: self-employed, 1.67 million won; wage earners, 1.49 million won; part-timers, 1.11 million won; and pensioners, 0.8 million won. The average income of total workout applicants was 1.325 million won.15

Applicants for rehabilitation were divided into two as DRBA provides, wage earners and self-employed. In the rehabilitation data, wage earners include part-timers and pensioners. Self-employed accounted only for 7.14 per cent in the rehabilitation sample. Average income of wage earners was 1.72 million won and that of self-employed was 1.66 million won, which was a little higher than that of the workout. Average income of total rehabilitation applicants is 1.720 million won.

Rehabilitation applicants had larger incomes than applicants for the workout, as Graph 18.7 shows. About 45 per cent of rehabilitation applicants had a monthly income of over 1.5 million won compared to 27 per cent of workout applicants.

Around 15 per cent of workout applicants received support payments from a third party. Most (81.5 per cent) of them received support from a spouse. In most of these cases, the wife fell in debt for her husband’s business (or vice versa). The workout and the rehabilitation do not have a joint application and pooling system for the spouses. Instead, they treat the husband and wife

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14 Monthly income in this section.
15 GNI per capita in 2005 was US$16,291 in 2005 (World Bank), which accounted for 1,300,000 won a month.
separately. In 49 workout cases out of 1,000 (4.9 per cent) the spouse of the applicants also applied for the workout program. In the rehabilitation samples, only 1.7 per cent of applicants reported that a family member had also applied for a rehabilitation proceeding.

iv. Living expenses

Living expenses were a factor where some discretion could be given. The workout and the rehabilitation use the minimum living expense set by the government in accordance with the National Basic Living Security Protection Act as a starting point. The workout allows 90 per cent to 150 per cent of the minimum living expense as living expense in the program. The rehabilitation, however, set 150 per cent of the minimum living expense as a standard for the repayment plan. Graph 18.8 illustrates this difference. Average living expense per head was higher in the rehabilitation than in the workout in all ranges of family size.

Graph 18.6 Income

Graph 18.7 Living expenses
IV. RESCHEDULING

A. Payment Period

The repayment plans set the maximum period in the workout (eight years or 96 months) and the rehabilitation (five years or 60 months). The workout took 96 months in 94.92 per cent of cases and the rehabilitation 60 months in 85.32 per cent of cases. Most applicants preferred to repay over the maximum period because their income could not cover living expenses and the required amount of repayment. Only 5 per cent in the workout and less than 9 per cent in the rehabilitation wished to complete the repayment in a shorter period.

B. Reduced Debts

The core of a repayment plan is to reduce the amount of debt including principal and interest. There is no restriction on the amount of reduction in the rehabilitation proceeding with the exception of a few non-dischargeable claims. However, under the workout plan, only 30–50 per cent reduction in principal of written-off claims is possible; there can be no reduction in principal of normal claims. Interest, on the other hand, can be fully reduced in both plans. Interest on rescheduled debts, which are deferred until the repayment period ends, can be reduced additionally if a workout plan is implemented successfully.

The total amount of debt reduction in the rehabilitation was 80.8 million won on average and 14.3 million won in the workout. As far as the amount of reduced claims is concerned, a workout cannot compete with rehabilitation.

V. EPILOGUE

When policy makers and legislators consider introducing new policies or schemes to fix a situation, they are concerned about several things: whether their choice is right theoretically, whether people will respond to the new schemes as they expect and whether the new rules may have negative effects on other issues. What matters most is not the existence of rules but the effectiveness of a new scheme, unless they just intend to give lip service.

As far as money is concerned, the bankruptcy proceeding is more favorable to bankrupt debtors than any other rehabilitation proceeding. Debtors can be discharged and wiped clean of any future repayments in a bankruptcy proceeding. Consequently, the number of bankruptcy cases is usually higher than that of the rehabilitation proceeding in many countries. When Korea struggled with credit defaulters’ issues in the early 2000s, however, only a handful of people turned to the bankruptcy proceeding because of a stigma against judicial processes and
especially against the bankruptcy proceeding. There must be a non-monetary cost in using the bankruptcy proceeding. People estimated that the cost of the bankruptcy outweighed its benefits. Though discharge, the most eminent incentive of bankruptcy, was first rendered in 2001, the number of bankruptcies has continuously increased as discharge became common in bankruptcy cases. At least to some debtors, actual benefits overruled emotional resistance and the notion of a stigma against judicial processes seemed to be exaggerated.

When designing the rehabilitation and the workout, policy makers and drafters tried to give incentives unavailable in the bankruptcy proceeding. Also designers of both programs recognized and competed with each other. A weak point in one program became a strong point in another program. The intrinsic weakness of the workout is that the workout plan cannot reduce claims as much as needed because the workout is based on creditors’ agreement. The intrinsic weakness of the rehabilitation is that it is a judicial process, which is hard to be familiar with for those who initially hate the court.

As Table 18.1 shows, in 2006 the number of bankruptcies surpassed that of the workouts as well as that of the rehabilitations. It means that debtors have overcome their sentimental resistance against bankruptcy and judicial processes. They chose a more favorable scheme according to their situation. As statistics in previous sections show, they acknowledge the difference between the programs, which implies that the intention of policy makers has been conveyed to debtors. The tendency seems to continue; the number of bankruptcies will grow and that of the workouts will diminish unless the latter provides incentives to surpass the advantage of straight bankruptcy.

Still two questions remain: why the number of rehabilitation proceedings is smaller than that of the workout and why the majority of credit defaulters still do not use any program at all. Judicial processes still seem to be burdensome as compared with the workout. The fee for the workout is only 50,000 won, but that for the rehabilitation is over 1,000,000 won. Emotional resistance against turning to judicial processes seems to be strong for debtors who seek some kind of relief involving repayment.

Until 2006, several programs on personal bankruptcy were reported to cover 1,000,000 debtors. However, around 3,000,000 debtors are still registered as credit defaulters in Korea. The question is why they do not turn to a program. Is it because of a lack of information on the programs? Or is it because of the lack of desire from people to fix the problem? Society wishes debtors to live a decent, humane life working diligently without being suppressed by excessive debts. It is our job to find out the factors which hinder them to use current programs.

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16 On the non-monetary cost of bankruptcy, see Oh above, n 1, 616.
17 Discharge ratio (number of cases rendering discharge to number of application for discharge) was 77.5 per cent in 2002, 89.5 per cent in 2003, 97.6 per cent in 2004, 98.9 per cent in 2005 and 97.9 per cent in 2006. (Source: Supreme Court of Korea.)
ON A DULL afternoon in late June 2007, the British Prime Minister, Tony Blair, walked out of 10 Downing Street for the last time. The evening signalled the end of his presence and distinguishing career in British politics. That same afternoon saw Gordon Brown, Chancellor of the Exchequer since the election of May 1997, which had ended 20 years in the political wilderness for the Labour Party, appointed as Prime Minister. The curtain had fallen on a definable political epoch.

This Chapter is concerned with only one aspect of this decade. It is the matter of serious personal overindebtedness and the political and administrative reaction to an increasing and complicated phenomenon over the selfsame period and is framed by two specific political and economic characteristics of the ‘Blair years’.

The first reflects one of the ways in which Britain, and its politics, has changed over this period. This is the acceptance that the notions of a market-led economy and that of social welfare and justice are not politically mutually exclusive—albeit that the precise balance of this juxtaposition has yet to be determined. Furthermore, this positioning is also consistent with such matters as the eradication of age and child poverty and social exclusion, the progression of a society increasingly open and liberal1 in its inter-personal attitudes and conventions and which is outward-looking and sometimes interventionist in its relationship to the outside world.

1 This should not be confused with an increase in the centralisation of state control, a reduction in the importance of Parliament, diminished local democracy, restrictions of civil liberties, a Presidential approach to government aided by ‘special advisors’ and consequential marginalisation of the Civil Service, Cabinet-based and ministerial responsibility—all of which have accelerated in the UK since 1978. See S Jenkins, Accountable to No one (London, Penguin, 1995) and Thatcher’s Children (London, Penguin, 2006) and P Osborne The Triumph of the Political Class (London, Simon & Shuster, 2007).
The second, and the principal claim of the ex-Chancellor, is the longest period of unbroken growth in recent history. Combined with low inflation, unemployment and interest rates, this benign economy has led to increasing prosperity for the bulk of the UK population. Beneath this indisputable and enviable crust, however, are the less appetising manifestations of a massive increase in the balances of unpaid household debt; domestic asset price bubbles; unsustainable levels of consumer borrowing powering the economy; aggressive and unfettered credit market behaviour and increasing recourse to personal formal and informal insolvency mechanisms. All have been politically sanctioned. Latterly, established principles of public policy in insolvency have been attacked by lenders. In short, this growth has yet to be paid for.

Marching with this particular economic beat of expanding domestic consumption and increasing financial delinquency there has been, nevertheless, a quieter drum that has signalled a very significant era of reform. It has sought to answer the difficult and matching question, put colloquially, of ‘What happens if the glass breaks?’ This is to ask, when put more formally: ‘If there is a breakdown in an individual’s array of credit-bargains, and particularly in a multi-creditor situation, what should be the philosophical and practical public policy response, at both the macro (aggregate) and micro (individual) level’?

This Chapter describes and analyses a period which, it is suggested, will be regarded as one which generated a unique response to this question in the context of the prevailing and the politically generated economic and social conditions. It also provides the background thinking and academic input to this process and generates some new conclusions on the topic of regime design for overindebtedness. Regime design is defined as that construct of philosophical and political drivers and objectives, informal and formal mechanisms, individuals, institutions, market operations, regulations and legislation whose forms and interactions provide the framework within which serious personal overindebtedness is addressed. This umbrella covers the most senior policy-making decisions and the practical demands of daily administration.

II. POLITICAL CONTEXT

Despite the UK’s serious economic difficulties of the 1970s and the creation by the Conservative Government of the two politically induced recessions of 1979–81 and 1989–93, the executive had no interest in personal insolvency reform. This was despite the blatant need, and the evident inequalities that the then regime generated and their promises to the contrary. The election of ‘New Labour’ in May 1997 heralded a sea-change. Political attitudes now became a driver for reform. This new positioning coincided with a determination by the

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2 Sixty-two consecutive quarters of growth (Q4 2007)—this in fact started in 1993 under the Conservatives.

3 See Table 19.1.
Table 19.1—Lending to Individuals 2001–2007

<table>
<thead>
<tr>
<th>NET LENDING BALANCES TO INDIVIDUALS 2001–2007² (£ Billion)</th>
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<tbody>
<tr>
<td>----------</td>
</tr>
<tr>
<td>a. Lending on Dwellings</td>
</tr>
<tr>
<td>b. Other Consumer Credit*</td>
</tr>
<tr>
<td><strong>TOTAL</strong></td>
</tr>
</tbody>
</table>

*Includes Credit Cards 40 44 56 60 60 55 55 53.6 55

Notes
1. The rate of growth late 1997 to early 2006 on (b.) is between 12–15%p.a. compound for each period.
2. For (b.) the overall seasonally adjusted growth rate has been falling steadily since a peak of just over 16% in October 2002 to 10% in December 2005 and lower through 2006. The 12-month growth rate has been steady at 5.2–6.0% during 2007. Some Credit Cards have been repaid.
3. The estimated value of UK household balance sheets is £3.6billion (2005).
4. There are important differences between (a.) & (b.) in terms of 'structural' and predictive relationships.
5. There was a growth in net disposable income 1997–2002 which stabilised thereafter and began to fall. In 2007, for the first time, in real terms this became a negative position. House prices in general have tripled since 1997 and are almost doubled in real terms. Total debt as a % of the disposable household income now stands at 160% considerably higher than the USA, Spain, Germany, France and Italy. Savings have fallen consistently from 10% in 1997 to 5% in 2006. (Negative excluding company pension contributions).
6. Of the £224 billion outstanding, the exposure to delinquency is not known. Estimates are £25–50 billion. Provisioning is not taking place at a commensurate rate.
7. Formal Personal Insolvencies in the UK in 2006 were 122,376: England & Wales: 62,396 bankruptcy and 44,332 IVAs; Northern Ireland: 1036 bankruptcies and 774 IVAs; Scotland: 5430 sequestration and 8208 Trust Deeds. The numbers for 2007 are almost identical. However, this understates the case and is misleading. It excludes the 15–20,000 excluded from the IVA total because of market interference by the lenders.
8. This annual aggregate level of formal personal insolvencies is equivalent to the working population of one of the UK’s cities ranked 13–20 (2001 census) e.g. Plymouth, Belfast, Nottingham, Newcastle, Hull.
9. Over the period 1997–2007 inflation has run generally at ± 2.0%; interest rates at 3.5/5.75%; growth at 2–3%; unemployment (claimant count) 5–6%. But the current account deficit is 5.7% of GDP (Q3 2007 Institute for Fiscal Studies); Public spending (post Northern Rock) is 44% of GDP—the Government imposed maximum is 40%.

1. Source: Insolvency Service
2. Source: Bank of England, Office of National Statistics—the remainder of notes
new management within the Insolvency Service (INSS), the relevant agency of the then Department of Trade and Industry (DTI)—now the Department of Business, Enterprise and Regulatory Reform (DBERR)—to review the efficacy of both personal and corporate insolvency arrangements, unchanged since the 1986 Act—which was based on the thinking and experiences of events of the mid-1970s—and put forward for consideration, where appropriate, proposals for reform. The Government for its part had, initially, to the forefront the economic issues of encouraging and sustaining entrepreneurship, increasing levels of output and productivity, and more efficient markets and competition. This was joined latterly by social welfare concerns and the acceptance of the need to rehabilitate more effectively those emotionally and economically distressed individuals and households that were within the working and spending economy.

The practical convergence of these demands was the need for an insolvency regime pertinent to the UK economy for the new millennium, and which specifically recognised the importance and complexities of the retail credit market, its recent and exponential growth and the new phenomenon of the consequential levels of personal overindebtedness. Furthermore, it needed to be intellectually and politically defensible.

The latter is a critical matter for those who attempt reform. At the senior political level this has two bases. The first is the aforementioned deliberate use of insolvency law and mechanisms as part of the enactment of macro-economic and social welfare policies. The second is quite new. It is directly derived from the recent phenomenon of the unrestrained expansion of personal borrowings, accelerating unpaid balances on unsecured personal credit and rising financial delinquency. Furthermore leading politicians have no experience of this damaging combination and it presents, therefore, a significant potential personal and governmental risk at ministerial level if not managed effectively. Hence the importance of the question ‘What happens if the glass breaks?’ For senior civil servants the questions are, first, how can the responses to the question be translated into a coherent regime that covers the whole spectrum of situations and demands of overindebtedness and, second, what should be the principles and methodology that determine this construct and its design.

The initial practical response by the Government at the beginning of its second term of office was the flagship Enterprise Bill in June 2001 with, inter alia, significant changes to the personal bankruptcy provisions and the INSS financial arrangements coming into force in April 2004. The Service’s response was two major consultation documents: ‘Bankruptcy—A Fresh Start’ in April 2000; and ‘Business Reconstruction and Company Rescue Mechanisms’, also in 2000.

4 The link between entrepreneurialism and the insolvency regime in determining and executing macro-economic policy was first formally declared in the DTI Competitive White Paper of December 1998, followed by Treasury Documents on UK Productivity and the Enterprise Culture (2000 and 2001) and the Ministerial introduction to the Enterprise Bill (2001). Heavily influenced by the US experiences, particularly of Gordon Brown (Chancellor) and Peter Mandelson (DTI Secretary of State at that time).
Later, a programme of research was instigated to generate some much-needed empirical data in both areas.

III. PERSONAL OVERINDEBTEDNESS RESEARCH

In May 2001 the INSS commissioned a major research study into the Individual Voluntary Arrangement (IVA) process specifically; personal overindebtedness generally; the effectiveness of the formal regime of insolvency; the relationship between informal and formal mechanisms; overindebtedness and macro-economic risk; and regulation of the process. The project\(^5\) was to have a rigorous, defensible framework, generate new empirical data and recognise existing research and the literature.

Outwith the legion fieldwork issues relating to new data, three fundamental difficulties soon emerged—the absence of an overall approach to and definition of overindebtedness; no satisfactory methodology for the measurement of overindebtedness, and its associated implications in terms of risk at either the macro or micro level; the absence of an existing English literature that dealt with the normative and practical issues in overall regime design in the context of an holistic and comprehensive approach to overindebtedness.

These difficulties were approached as follows. The first was met by disregarding the conventional approaches to the definition of overindebtedness and adopting a conceptual approach that recognised the inherent characteristics of overindebtedness, and that along the theoretical pathway of the decline over time from financial stability to serious economic distress there are different levels of debt and overindebtedness which may be more or less amenable to rescue depending on the circumstances and situation of the debtor. This may be described as a ‘debt curve’, where the economic profiles of individuals may range from those with temporary difficulties to those in the dependent economy who may have long-term debt problems.

The research\(^6\) recognised that any new regime directed to address overindebtedness needed to recognise these gradations and the different financial and social situations of debtors. For example, one critical distinction is between those debtors in the working economy and those in the dependent economy. The latter would include the approximately 5 million individuals and associated households receiving unemployment, disability and other benefits; pensioners with no or only minimal private pension support; dependent students; and those in work where working tax credits form a significant proportion of household income. The research also identified the presence of the conflict resolution

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\(^6\) The treatment of the first, second and third fundamental difficulties, namely definition, measurement and methodology are dealt with in M Green, ‘Regime Design and the Seriously Over-Indebted—A New Methodology’ (2007).
<table>
<thead>
<tr>
<th>Location* on Fig. 1</th>
<th>Activity Providing or Administering Institution(s)</th>
<th>Nature of Principal Activity and Purpose</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>Advisory</td>
</tr>
<tr>
<td>R1</td>
<td>County Court Judgement; Enforcement; Garnishee Order; Charging Order; Repossesion Order</td>
<td>The Court and Judiciary, Baliffs</td>
</tr>
<tr>
<td>R1</td>
<td>County Court Administration Order; Attachment of Earnings Order (Multiple)</td>
<td>The Court and Judiciary, Baliffs</td>
</tr>
<tr>
<td>R2</td>
<td>Debt Management of Single Debts or Multiple Debts with a low aggregate value</td>
<td>Charitable Institutions eg NaCAB, Money Advice, et al—Non Profit Making</td>
</tr>
<tr>
<td>R3</td>
<td>Credit Repair advice for a fee—generally regarded as worthless</td>
<td>Commercial Businesses profit making</td>
</tr>
<tr>
<td>R4</td>
<td>Debt Consolidation: Mainstream, some Alternative</td>
<td>Financial Institutions—some Mainstream, some Alternative</td>
</tr>
<tr>
<td>R5</td>
<td>Debt Management Plans (DMPs): ‘Free’2</td>
<td>Charitable Trust or Profit Maker funded by Creditors</td>
</tr>
<tr>
<td>R6</td>
<td>Debt Management Plans (DMPs): ‘Fee Paying’2</td>
<td>Commercial Profit Making Business</td>
</tr>
<tr>
<td>R7</td>
<td>Individual Voluntary Arrangement3 Practitioner</td>
<td>Court6, Judiciary6, Insolvency Practitioner</td>
</tr>
<tr>
<td>R8</td>
<td>Fast-Track IVA7</td>
<td>Insolvency Service Court</td>
</tr>
<tr>
<td>B</td>
<td>Bankruptcy4</td>
<td>Judiciary, Insolvency Service, Insolvency Practitioner</td>
</tr>
</tbody>
</table>
market for overindebtedness, revealing an overlapping set of institutions which had grown partly in response to suppliers seeking market opportunities and partly to existing legislation, some of which (administration orders in the County Court) were in need of reform or abolition (See Table 19.2).

A. The IVA Research

The research on IVAs established, inter alia, that:

- The IVA process itself, whilst without exception well regarded in principle, was wasteful in terms of cost and administration; slow, inappropriate and bureaucratic in operation; threatening to the debtor by way of its association with the court; costs were excessive in relation to returns to creditors and associated cash flow payments were excessively dilatory.
- The IVA was now predominantly used for ‘consumer debtors’, not business-related debtors as originally intended—less than 10 per cent share for the latter.
- All the formal processes were court driven, despite the fact that it was not possible to validate any added value from their involvement or the need for their presence, outwith enforcement, if the civil matter of credit-bargain breakdown could be settled outside the court.
- Despite the fact that the IVA process—as an alternative to bankruptcy and for those in serious distress who could not repay their debts in a multi-creditor situation in five years or less—was a more advantageous process than a Debt Management Plan (see Table 19.3), the IVA was being massively outsold by DMPs and consolidated loans, no matter how inappropriate this was in terms of ‘best advice’.
- Access to all forms of resolution for rehabilitation was poor, as was debtors’ understanding of the options and the locus of help.
- There was a growing informal supply-side presence that was unregulated and whose characteristics were unknown.
- Bankruptcy provided minimal returns to creditors. Less than 18 per cent of all executions led to any recovery for the creditors and less than 10 per cent led to any kind of Individual Payment Order post bankruptcy.

(Notes to Table 19.2 opposite)

1 Principally refinancing
2 Principally re-scheduling
3 Can be 1 and 2 plus Forgiveness and Asset Sales
4 Forgiveness plus distribution of all available assets and some future income. Conflict Resolution when a debtor’s petition
5 Formal processes are regulated; informal processes are not
6 Rarely used after Insolvency Act 2000
7 Result of 2002 Enterprise Act. Terms dictated by the Official Receiver (INSS)
8 Individuals entering R7 (IVA) often had experienced many of R1–R6 (inc.)
• The regime had failed to recognise the shift in retail credit volumes—in particular changes within the operation of credit markets, lending and credit risk criteria, credit delinquency and the consistently rising level of unpaid balances.

• The changing nature of the UK’s economic mix and employment—and their consequential demands—were similarly being disregarded.

• The structural nature of the cases of serious overindebtedness had changed significantly. The conventional thinking stated that this was the result of major events disturbing the medium-term household economy—death, serious illness or accident, unemployment etc and historically this had been the case. Now, however it was found that, for those in the working economy, the principal reason for overindebtedness was almost exclusively overspending and the excessive use of unsecured credit.7 For those in the dependent economy lack of income (poverty) was the principal cause.

• For those in work the IVA is a far more effective recovery mechanism than bankruptcy for the creditor, debtor and the State.

7 Confirmed by subsequent studies: 300 randomly selected IVA cases at a leading IVA house (the author, 2005); several thousand cases dealt with by a major ‘one-stop shop’, 2005; a large volume (6,000 cases) study by PWC—an IVA creditors’ agent, 2006.

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**Table 19.3 Individual Voluntary Arrangements compared to Debt Management Agreements**

<table>
<thead>
<tr>
<th>Item</th>
<th>Product element</th>
<th>DMA</th>
<th>IVA</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Includes all assets and liabilities?</td>
<td>No</td>
<td>Yes</td>
<td></td>
</tr>
<tr>
<td>2. Will automatically include debts from all unsecured creditors, for example utilities, rent, council tax</td>
<td>No</td>
<td>Yes</td>
<td></td>
</tr>
<tr>
<td>3. Runs for a fixed term: is the term certain?</td>
<td>No</td>
<td>Yes</td>
<td></td>
</tr>
<tr>
<td>4. The agreement is binding on all creditors, that is, no ‘contracting out’</td>
<td>No</td>
<td>Yes</td>
<td></td>
</tr>
<tr>
<td>5. The debts can be rescheduled</td>
<td>Yes</td>
<td>Yes</td>
<td></td>
</tr>
<tr>
<td>6. The debts can be forgiven, that is, written off</td>
<td>No</td>
<td>Yes</td>
<td></td>
</tr>
<tr>
<td>7. Entering into an agreement will automatically stop all creditor harassment and court actions</td>
<td>No</td>
<td>Yes</td>
<td></td>
</tr>
<tr>
<td>8. Entering into an agreement will automatically stop all future interest and other charges</td>
<td>No</td>
<td>Yes</td>
<td></td>
</tr>
<tr>
<td>9. If the agreement terms are met then all debts are automatically extinguished even if not paid in full</td>
<td>No</td>
<td>Yes</td>
<td></td>
</tr>
<tr>
<td>10. All the debts have to be repaid</td>
<td>Yes</td>
<td>No</td>
<td></td>
</tr>
<tr>
<td>11. If there is a problem with the agreement during its term there is a regulatory body to refer it to</td>
<td>No</td>
<td>Yes</td>
<td></td>
</tr>
<tr>
<td>12. Appears on credit scoring records?</td>
<td>Yes</td>
<td>Yes</td>
<td></td>
</tr>
<tr>
<td>13. The agreement is approved by the court</td>
<td>No</td>
<td>Yes*</td>
<td></td>
</tr>
<tr>
<td>14. Is the principal dwelling protected?</td>
<td>No</td>
<td>Yes**</td>
<td></td>
</tr>
</tbody>
</table>

* Since 1 January 2003 there has been the ability to agree an IVA which does not need court approval.
** IVA may require equity release in Year 4/5.
• Either mechanism—IVA, DMP, bankruptcy—led, almost without exception, to individuals being credit-barred for six years by mainstream and most sub-prime lenders. This still remains the case.
• There was no empirical evidence that supported the claim that the costs of self-petitioned bankruptcy were a constraint to entry—purely anecdotal reportage that could not be substantiated.
• Data availability on IVAs was very poor.
• There were debtor and creditor needs not dealt with effectively by the then available mechanisms. These included for the debtor issues such as access to and clarity about available mechanisms, uncertainty over ‘best advice’ and concerns over the performance and capability of providers. Creditor concerns included the slow speed of payment; the high level of fees in IVAs; the quality of monitoring and regulation of providers; and uncontrolled promotional activities by providers.

In summary the formal regime, dominated by the notion of bankruptcy, and disregarding the growing presence of informal activities, the structural change in overindebtedness, and the increase in unsecured credit balances was no longer well matched to the variety of situations of overindebtedness. It failed to meet the objectives of recovery and rehabilitation and respond to changes in the market and social economy. The need for reform was axiomatic.

IV. A TEMPLATE FOR REFORM

The proposed overall framework for reform and based on the Research with its radical change of emphasis, prospective structure and mechanisms, is outlined at Figure 19.4. This ‘vision’ for reform of the formal regime, based on an holistic approach to serious overindebtedness had 13 new underlying principles and public policy directives:

(a) the IVA process, for those in work, should be preferred to bankruptcy and, therefore, should be the initial alternative within the formal/informal regime and hence seen as the ‘gateway criterion’. This approach will minimise the cost to the state and result in higher yields for creditors;
(b) bankruptcy should be seen as a last resort and principally directed against those who ‘can pay but will not’ or have been guilty of some offence or where the medium-term economics for recovery are hopeless;
(c) the regime should move from a judicial to an administrative basis unless there was empirical and persuasive evidence that this was inoperable;
(d) where market providers within the conflict-resolution market could administer the mechanisms this should be the route rather than publicly funded entities or the court;
(e) the range of mechanisms within the regime should be extended to reflect more appropriately the practical demands of the overindebted and the credit market;
Table 19.4 Proposed New Format for the Formal Insolvency Regime (2001) - Basic Processes (Assumes the Abolition of the County Court Administration Order)
these mechanisms should be specifically directed to remove those mismatches between ‘needs’ and ‘availability’. That is to say, the regime would attempt to address the different needs of those in differing positions on the ‘debt curve’;

that the State should be protected from incurring additional costs—other than where poverty and low income is the general basis of overindebtedness, as in the dependent economy—and that debtors and creditors should foot the bill, that is, there should be no costs of ‘externalities’;

that the principles of ‘can pay will pay’, and maintenance of commercial morality, should remain central to the system;

it must recognise the implications of the changing retail credit market such as the rapid expansion in number of products and suppliers, weak assessment of individuals’ credit risk in relation to ability to repay, the use of statistical models ill-designed to cope with conditions of change; increasing incidence of unpaid balances, and profits generated not from lending but from fees, penalties, excessive rates of margin for delinquency;

for those in the dependent economy the issues are fundamentally those of low income/poverty, and policy making should address these issues;

it should be recognised that there are opportunities within the criminal and civil law for debtors to be sanctioned by creditors when fraud or deceit are suspected. Such powers are rarely used;

it must recognise the issue of potential abuse by debtors and creditors and specify sanctions to deal with potential abuse;

the regime must be capable of dealing with both consumer and business debtors who are seriously overindebted and recognise the demands of government policy in encouraging an entrepreneurial culture.

These changes in principle and public policy directives were of fundamental importance at a secondary level in determining the structure and content of the new mechanisms. However, at the primary level and underpinning these innovations was a major shift in philosophy. Historically, and since time immemorial the legislation and practise had been driven by the view that for insolvent and seriously distressed personal debtors with no connections to trade, there was an umbilical link between financial failure and moral failure. The new thinking refused to accept this positioning as the principal driver of the regime, nor could it remain a central tenet of its new structure. The critical matter of moral hazard should be dealt with separately and by a different mechanism and related sanctions.

The consequential new structure and mechanisms associated with these principles would be:

(a) the Debt Relief Order—for those with few assets and insufficient income to support an IVA;

(b) the Debt Moratorium Order (Enforcement Restriction Order)—for those with a temporary break in income flow and who are expected to resume earning within eight months of the Order;
(c) the Debt Cancellation Order—for those whose long-term inability to repay has been the result of damaging matters outside their control, such as medium-term unemployment, long-term disability, serious accident, family breakdown. In the case of a general recession this might include the cancellation or modification of secured debt;

(d) significant reforms to the IVA process to provide a simpler, less bureaucratic process that would provide better yields for creditors. This would recognise the fact that approximately 80 per cent of all IVAs with debts of less than £75,000 are routine;

(e) bankruptcy reforms—to be determined by ‘can pay but will not pay’ and/or criminality; the need for sanctions; and the nature and extent of the overindebtedness. It should include the initial 2001 Enterprise Bill Reforms, but also recognise that non-business bankrupts were a significant group that must also be accommodated—a fact overlooked in the initial reforms;

(f) the abolition of the County Court Administration Order and its replacement by an effective, simpler, cheaper IVA, for those who could afford to pay £50 or more per month. The rules would be consistent with those for the reformed bankruptcy mechanism. It would deal with relatively low value debts and those currently excluded from IVAs, that is, those with debts between £5,000 and £25,000.

The purposes of the Debt Relief Order are to remove this class of debtor from the bankruptcy regime and provide a mechanism specific to those who are generally within the dependent economy. This scheme puts the IVA process, its inherent characteristics and the principle of ‘can pay, will pay’ as the gateway for personal insolvency, and hence it becomes the initial basis for decision making on the choice of path for the overindebted. The entire balance of the regime changes completely. Bankruptcy now becomes but one leg of the platform. The regime has a completely different emphasis, and an enhanced array of objectives and choice of relevant options for both debtors and creditors. This proposition, by definition, demands a major shift in attitude and understanding. If executed, it would thereby progress thinking for the first time in several generations.8

The timing of this proposition coincided with the draft insolvency reforms in the Enterprise Bill (2001), which only addressed bankruptcy reform and conceptualised a liberalised bankruptcy regime as a mechanism for encouraging entrepreneurial risk taking but whose major impact would be on consumer debtors who represented the majority of petitions. The future for the major shift in principle suggested here therefore looked bleak. Indeed, David Milman in 2005 suggested that ‘the Enterprise Act has frustrated such a policy goal by making bankruptcy (with all its weaknesses as a recovery device) more attractive

8 This approach had some echoes in the recommendations of the Cork Report (1982) but the dominant notion remained that of bankruptcy in the 1986 Act. New proposals, other than the IVA, for the individual debtor were excluded.
to debtors than the IVA appears to be’. Many contemporary commentators heralded the demise of the IVA as a consequence of the new legislation.

In the event these predictions were contradicted. The IVA is now dominating the centre stage. Some of the factors which resulted in this situation include: major DMP providers becoming ‘one-stop shops’ and changing what previously would have been long-dated DMPs into IVAs; the inherent attractiveness of the process for otherwise bankrupts and its non-court features; the ability of the debtor to retain the home; the perceived and continuing stigma of bankruptcy; the retention of control over household affairs; the ease of access and the anonymity of the transaction; a desire to repay what is possible over a five-year period even when bankruptcy is the better economic option; the heavy advertising of the supply-side providers; better yields for creditors than bankruptcy; and the facility for lenders to securitise their IVA debt.

This shift towards the IVA has been of immense practical importance but its success has also subsequently led to questions about the rationale for repayment regimes and the appropriate period of rehabilitation since these were not defined in the original legislation. It has also led to a demonstration of market interference by lenders.

V. CURRENT DEVELOPMENTS

The principal innovations and progress are summarised at Table 19.5. In short, with the exceptions of the Debt Cancellation Order in relation to catastrophe, and the need for a formal application to enter the process, the early template has proved to be a very resilient prospectus but not all the legislation is yet operational. There are, however, significant matters for concern. The original IVA research highlighted significant market and regulatory failure. Over half a decade later this position has not changed and the same weaknesses still remain. Similarly, the issue of paucity of data continues to bedevil and frustrate: this is important within a structure that has evidence-based policy making and consultation as one of its central tenets.

Umbilically related to regulatory and market failure are the issues of major lenders’ approach to IVAs. The current instability in the IVA market is considerable. In 2007 it is estimated that some 15–20,000 IVA candidates, qualified

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10 In addition, there are still pockets of exclusion where even the combination of market operations and the legislation still fails to provide a suitable remedy, that is, debtors with £15–25,000 of unsecured debt and £100–200 of available monthly payments.
11 This possibility was initially forecast in late 2004 as a likely result of the inadequate monitoring procedures by the insolvency regulators (RPs) and the probable and consequential lack of lenders’ confidence. Also with much more precision again in early 2006—see Michael Green, ‘Personal Over-indebtedness, the Conflict Resolution Market and Regulatory Implications’, May 2006, Chapters XI and XII. Its incidence was always a probability whenever the lenders realised the huge quantum of write-offs in aggregate associated with the developing IVA market. Estimated to have been between £1.5 and £2 billion in the context of the 44,000 IVAs in 2006. Until mid 2006 and similarly in 2007 the lenders had previously ignored the presence or likely impact of IVAs—‘below the radar’.
Principal Innovations 2000–2008

1. The Insolvency Act 2000 (IVA Reform I)
   In the case of Individuals Voluntary Arrangements the Act removed the necessity for an Interim Order (IO) which hitherto was the mechanism that allowed the process to start. The IO had previously to be approved by the Court. The first shift in moving personal insolvency from a Court-based/judicial system to an administrative system. The IVA became as a result quicker; cheaper; less bureaucratic; less threatening to the debtor; better access. Operational April 2003.

2. The Enterprise Act 2002
   a. Changed the rules ré bankruptcy established in 1986. Shortened the ‘normal’ discharge period from 3 years to 1 year (max.) , now 7 months on average. It also removed the restriction on bankrupts holding certain social offices. Gave more protection to the disposal of the home; now to be dealt with in 3 years—previously no time limit. But introduced the concept of Bankruptcy Restriction Orders (BROs) for misconduct with a maximum 15 years—(the most common reason is incurring debt without reasonable prospect of repayment). Average restriction just under 5 years; 2006 year to March 843 cases (2005 = 22 cases); 15 years = 3 cases : To end January 2007 = 1579 cases; 1300 suspensions of discharge. Removed Crown Preference.
   b. That bankruptcy is now easier is a myth—still mainstream credit barred for 6 years; pre-bankruptcy assets acquired still rest in the trustee for 3 years post-bankruptcy; 3-year income payment orders (arrangements) still exists—historically 9–10% of cases now 18–19% of cases (2005/2006); 21% in 2007.
   c. Bankruptcy is moving towards a process whose stigma is maintained/increased; specifically directed at ‘can pay, won’t pay’ and misconduct/criminality or where the economics are insoluble (see also DRO at 4a and Debtors Petitions at 5). Operational April 2004.

3. IVA Reform II
   a. Consultation process started summer 2004; final consultation completed; legislation will be via Regulatory Orders (legislation approved late 2006). Operational target is late 2008.
   b. Will radically simplify the process by introducing a ‘simple’ IVA (SIVA) for debts under £75,000; simple majority voting; no variations or amendments/modifications; remove redundant paperwork ré Courts; paper/electronic meetings. Could cover 80% of current cases—principally consumer debt. Remove significant levels of costs and delays and distress to the debtor. Improve process efficiency significantly. Will lead to lower prices and faster cash returns to creditors. Legal end of unused Trust Deed provisions
   c. Current rules for larger cases will remain the same. A market-operated process for rehabilitation and recovery administered by firms that have at least one licenced Insolvency Practitioner.

4. Tribunals, Courts and Enforcement Act 2007—Part V
   a. Debt Relief Orders (Ch. III)
      • Designed to accommodate those debtors with minimal assets (probably less than £1,000) and very little discretionary income for debt repayment (i.e. less than £50 p.m.) and who cannot access any other available remedies other than bankruptcy—which is becoming increasingly inappropriate (see 2.). It is for the financially excluded where total liabilities are to be less than £15,000.
• It will be administered by the Official Receiver—on line—with help from accredited advisors; no investigations unless requested; creditors informed subsequently; discharge and other provisions as per bankruptcy. Implementation imminent. Quicker, cheaper, fairer process than bankruptcy. Good for the debtor. Operational Spring 2009(E). Consultation ends January 2008.

b. Debt Moratorium Order (Ch. II)
• Recognised that in today’s fast-changing economic and credit society there will be cases where individuals/households short-term economic status may change quickly, and previously manageable commitments cannot be met for a short period. In those circumstances where repayments may be expected to recommence within 6 months a debtor may apply to the Court for an Enforcement Restriction Order (an unnecessary requirement—this would be as well effected by the market). This gives a stay of creditor activity for that period. No need for a judgement debt as a prerequisite.
• To be administered by the Courts; debtor can reapply after 6 months; trade debtors to be excluded (wrongly I feel i.e. self-employed trade debts personally incurred). Details still awaited. Implementation imminent already approved by Parliament. Good for the debtor. A mechanism directed to a specific purpose and need where previously there was no suitable remedy. Will stop creditors wasting their recovery costs. Operational Spring 2009(E). Consultation ends January 2008.

c. County Court Administration Order (Ch. I)
• Will disappear from the Statute Book. Its notional replacement will be an ‘Administration Order’—a low value, low repayment IVA under another name. Will deal with unsecured debts under £15,000; have pre-set and new prescribed rules and minimum repayment levels (£50 p.m. estimated). Consistent with existing bankruptcy and IVA legislation. No need for a judgement debt to enter as with old CCAO. To be administered by the Courts’ staff (no judicial involvement). Consultation ends early 2008. Proposed maximum repayment term—5 years.

d. Debt Repayment Plans (Ch. IV)
• Gives power to Lord Chancellor (Dept. of Justice) to approve DRPs that under the enabling powers and if brought into practice will allow composition, and cessation of interest and costs i.e. an IVA by any other name: will not involve a creditors’ vote—unlike an IVA. No other details as yet but probably a 5-year maximum repayment term and will deal with unsecured debt levels over £15,000. Consultation expected summer 2008. Legitimises DMPs (now part of informal régime) and brings them into the formal régime. Present proposals will generate jurisdictional conflict between the Dept. of Justice and the INSS.

5. Debtor Petitions in Bankruptcy
The Insolvency Service is looking to remove Court involvement as a routine principle—cheaper, quicker—and the process will be operated electronically by the Official Receiver. Only rarely is there any current added value by way of the Courts’ involvement. Feasibility project in progress. Consultation period ends January 2008.

6. Summary
An increasingly sophisticated array of measures has been generated that are designed to tackle specific areas of unsatisfied demands/anomalies/injustices/inefficiencies, that are identifiable from the Debt Curve Profile and where no suitable remedies previously existed. A massive shift away from the process domination of bankruptcy and a recognition of its poverty as an economic recovery and rehabilitation mechanism—less than 15% of bankruptcies now result in distributions: Can pay, will pay - always an influential criteria is now present in more practical mechanisms. Also heralds a major shift away from the Courts. Looks to reduce uncertainty within the processes.
as bankrupts, who previously would have been accepted have been denied access to the process by the actions of a significant clutch of the major lenders who have set high ‘hurdle rates’ of 40 per cent for debtors proposing IVAs. Whilst historically there have always been lenders who have demanded unfeasible rates of return (for example, 40 per cent) from bankrupts before they would vote for a proposed arrangement these were limited to small ‘fringe’ lenders who only rarely had the critical 25 per cent level of voting rights to block an arrangement. All the major lenders and finance houses supported a regime where minimum returns of 15–25 per cent, after costs, were considered acceptable. In practice, the general range was 25–35 per cent for the bulk of proposals (based on statements from leading PLC providers). Data on actual yields is not available but anecdotally, 20–25 per cent would find concurrence. The ‘strike’ by major lenders with significant voting rights was therefore a new and damaging initiative against the IVA process. These lenders have effectively taken over the statutory process and set new rules—establishing high rates of repayment (over 40%) as a pre-condition for acceptance of an IVA: there is now a serious and open conflict between their activities and the intentions of public policy.

The potential outcome is presently unclear, despite negotiations, working groups, the involvement of the INSS, the lenders’ trade body—the British Bankers Association (BBA)—and providers under the umbrella of the ‘IVA Forum’ which have been ongoing since early 2007. This produced in January 2008 an operational and agreed ‘protocol’ covering several administrative aspects. This should be very beneficial and if operated in both letter and spirit should also satisfactorily address the issue of hurdle rates. However, this is only a voluntary agreement and leaves as yet unsettled such issues as fees, exclusion and the treatment of house equity. Providers generally are highly sceptical of the lenders’ good faith and their commitment to perform.

The empirical basis for the lenders’ publicly stated reasons for their aggressive positioning since Autumn 2006, articulated strongly via the BBA, is both unsustainable and misleading. Their unstated objective is to reduce the write-offs related to the delinquent element of historical retail credit lending by several strategies: shifting individuals out of IVAs into DMPs; offering those eligible for IVAs unsuitable consolidated loans fixed to charging orders; simply have the distressed debt remain with collection agencies; or selling it to third parties. What is apparent is that the consideration of their own economics by the lenders is poor: nor are they disclosing the real level of potential delinquency to their third-party creditors or shareholders.

12 In any event this will demand a stringent analysis of the institutional structure surrounding this market and piece of public policy. See M Green, ‘The IVA Market, the Protocol and Institutional Adequacy: A Review and Analysis’ (forthcoming, 2009).

13 For example, extensive and major transgressions in the areas of: misleading advertising and ethical standards; inappropriate arrangements and ‘mis-selling’; excessive fees; provider discipline and public reporting of delinquency; provision of ‘wrong advice’.
This very damaging situation has as yet received no informed public or political exposure or debate. If it persists, long-term public policy will have been defeated by powerful commercial interests who have no democratic mandate. Their demand for increased yields will inevitably lead to a higher level of failures and the process will eventually be further discredited and hence be easier to attack. Furthermore, there is no statutory requirement for lenders to recognise DMPs—a position of refusal that existed in the late 1990s. If, indeed, their intention is to marginalise the IVA process, and they are successful, then they can subsequently control the entire personal debt recovery process outwith that of bankruptcy itself.

The final concerns are those generated by Part V of the Courts Tribunals and Enforcement Act (2007). The inclusion of Debt Relief Orders (Ch III) and Debt Moratorium Orders (Ch II), the latter clumsily and inappropriately named the Enforcement Restriction Order, are important and beneficial. They will be operated by the Insolvency Service and by the courts respectively. Other inclusions, however, cause deep concern. The first is the proposal to introduce a new mechanism called a Debt Repayment Plan (DRP) (Ch IV), which will permit the Lord Chancellor to approve composition (that is, write off a level of debt) and freeze interest and costs for certain DMPs, that is, create a new class of IVA, at the very time that the existing IVA process is scheduled for major legislative change and is under market duress. The second is the well-received and long-overdue proposal to abolish the County Court Administration Order (Ch I) and effectively create yet a further type of simpler, cheaper IVA with a maximum debt limit of £15,000. This will be administered by the courts, not the market as is now the case for IVAs.

These concerns have two different sources. First, the decision for the administration of the Administration Order to be by the courts and not the market is, apparently, the result of creditor pressure. This has no logic. The market deals with far larger debt levels already and there is no judicial involvement. Furthermore, this decision runs against the established grain of ongoing public policy of minimising court involvement.

Second, the enabling powers of the DRP (Ch IV) are wide, imprecise and dramatic. There is no detail and at present the legislation serves only to confuse. However, it does raise at this early stage two matters of serious principle. First, creditors will have no powers to vote on any approved scheme or specific arrangement—hence changing a well-established principle and practice on debt recovery in England. Second, by placing this mechanism within the control of

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14 Press comment has been of a uniformly poor quality.

15 This was a bizarre Bill in relation to overindebtedness. Promoted by the Department of Constitutional Affairs—now the Ministry of Justice—it was trailed by a Consultation Process, ‘Choice of Paths’, by the DCA (2004). It was mischievously put forward as ‘blue sky thinking’, which it was not (see Table 19.4) and the resultant Bill did not reflect properly the consultation response. The Bill was not promoted, received no press exposure and was slid into the legislative process generally unknown to the supply side of the conflict-resolution market despite its very important provisions. It received no informed Parliamentary scrutiny or external commentary.
the Department of Justice it creates a position of jurisdictional conflict. Since the early 1800s matters relating to insolvency have resided within a trade department (BOT; DTI, BERR) rather than Justice. Those who are eligible for the new DRP will be indisputably insolvent, and only capable of repaying their debts—if at all—by liquidating their assets.

The execution of this legislation will demand great care. Unlike other elements of reform already referred to it was not preceded by the collection of any empirical data nor a thorough understanding of the contract resolution market and its participants. It is not an example of ‘evidence-based policy’ in operation. Nevertheless, the principle of bringing more distressed debtors—that is, those currently subscribing to the approximately 100,000 new DMPs each year generated by the ‘fee-paying’ and creditor-funded providers (CCCS/PayPlan Partners)—into the formal regime is to be fully supported. The presence of a government approved ‘Kitemark’ debt repayment plan may attract new entrants from those ‘iceberg bankrupts’ previously recognised and these numbers could increase dramatically. Lenders would have to provide for these plans as should now be the case for IVAs and unlike current DMPs. Should enhanced regulation and monitoring of providers’ activities, performance and quality of advice follow as a consequence and part of the initiative then this will advance the regime considerably.

A. The Incidence of Formal Insolvency in England and Wales

Table 19.6 outlines the use of bankruptcy and IVAs from 1998 to 2008.

The bankruptcy data represent both individual debtor and creditor petitions. It is notable that whilst bankruptcy has increased significantly over the period, and particularly since 2002 (2.6 times), the IVA has expanded even more dramatically (seven times). The latter is due to: the exponential increase in personal unsecured credit balances becoming increasingly unsustainable; the entrepreneurial activities of a small clutch of supply-side providers; the increased public awareness of the process as a result of the advertising and promotional activities of these providers. This is a most interesting example of the demand for a legislative process being satisfied by the commercial market and not by governmental activities or support.

The volume of creditor petitions has remained stable since 1997/98 at 8–10,000 per annum. In contrast, the number of debtor petitions has risen sharply and

<table>
<thead>
<tr>
<th>Year</th>
<th>1998</th>
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<th>2005</th>
<th>2006</th>
<th>2007</th>
<th>2008</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bankruptcies</td>
<td>19.6</td>
<td>21.6</td>
<td>21.5</td>
<td>23.5</td>
<td>24.2</td>
<td>28.0</td>
<td>35.9</td>
<td>47.3</td>
<td>62.6</td>
<td>64.5</td>
<td>67.4</td>
</tr>
<tr>
<td>IVAs</td>
<td>4.9</td>
<td>7.2</td>
<td>8.0</td>
<td>6.3</td>
<td>6.3</td>
<td>7.6</td>
<td>10.7</td>
<td>20.3</td>
<td>44.3</td>
<td>42.2</td>
<td>39.1</td>
</tr>
</tbody>
</table>
represents 84.4 per cent of all bankruptcies in 2007. Of creditor petitions the most common petitioner is the Crown, peaking in 1999/2000 at 65 per cent but falling to 45 per cent in 2005/06. Local authorities have shifted from 1 per cent in 1992/03 to 25 per cent in 2005/06 stand at 7 per cent principally for domestic rate defaults. Accountants, as agents, have also shifted from 1 per cent to 7 per cent and now trade creditors have fallen from 29 per cent to 10 per cent. Insurance companies have fallen from 3 per cent to 1 per cent. Banks and financial institutions collectively have declined in importance after peaking at 15 per cent in 1994/95 following the end of the last recession, and have remained at about 10 per cent since 2004/05. Over the period the level of self-employed bankrupts has fallen as a proportion of all bankrupts from 53 per cent to 17 per cent but numerically have remained consistent at 10,000 per annum. This reflects, no doubt, the benign economic conditions in recent years as does the fall in cases executed on behalf of the Crown or trade creditors.

It is not possible from the available data to distinguish between debtor and creditor petitions. What can be said at the aggregate level about the characteristics of bankrupts in 2006/07 is that the ratio of men to women is still falling (61 per cent in 2004/05; 56.7 per cent in 2006/07) but is still above the population norm of 47.9 per cent (2001 census); the average (mean) age is 42 and relatively consistent, with females slightly younger; second-time bankrupts are in decline from 2.5 per cent in 2004/05 to 1.6 per cent in 2006/07; the figure for bankrupts who have been in an IVA is falling (2006)—now at 2.4 per cent (unweighted); that for self-employed bankrupts continues to fall—17.3 per cent (2006); that for those with no work has increased to 47.4 per cent. Average asset levels excluding property were £3,775 and £18,901 with over half of bankrupts having no assets; average debt (mean) levels were just over £50,000. If the 8,000–10,000 annual business bankrupts were excluded from the bankruptcy population then the property ownership, asset level and debt levels would fall considerably further. In the case of debtor petitions it is probable, but statistically uneviedenced, that the bulk would be located in the dependent economy.

B. Individual Voluntary Arrangements

The uptake of this process has shown a dramatic increase since 2003 both in terms of its relationship to bankruptcy and to the use of informal debt management plans. Without the actions by the banks in late 2006, and throughout 2007, the ratio of debtor bankruptcies to IVAs in 2007 would have fallen to less than 1:1. In 2006 the actual ratio was 1.4:1; in 2002 it was 3.8:1. The change in the relationship with debt management plans is equally striking. In 2002 the ratio was estimated to be of the order of 10/12:1 in favour of DMPs. In 2006 this was probably of the order of 2:1. Creditor activities in 2007 have led to an increase in this ratio which probably now stands at 3:1 or 4:1 as providers have switched IVA proposals, which would now be rejected by lenders, into very long DMPs.
The original research in 2001 and subsequent studies in 2006 and 2007 have revealed a remarkable consistency over the period in some major characteristics of IVAs and the debtors, for example the average (mean) debt level is likely to be between £55,000 and £62,000; costs will be of the order of £6,000–£8,000 (ex VAT); payments are in the range of £250–£600 per month. Individuals are likely to be between 25 and 50 years old, employed, asset-owning and excessively geared. The extent of home ownership is uncertain—perhaps 50 per cent. Creditors’ net yields are likely to be 20–25 per cent; proposed yields after costs about 35 per cent. The detailed time profiles of completions and failures have remained remarkably stable over the period. Over 95.5 per cent of failures have occurred by month 66 and 85 per cent of successful completions similarly.

Over recent years the underlying purposes of the IVA process and the basis for decision making has changed. Originally, this was simply whether, at the time when the proposal for an IVA was put forward, the benefits to the state, the debtor and the creditor would equal or exceed those from the execution of a petition for bankruptcy. The IVA was designed for those business debtors (for example, sole traders, partners, directors with guarantees) who could submit a debtors’ self-petition for bankruptcy. Now over 90 per cent of IVAs relate to consumer bankrupts. It was also originally envisaged that the acceptable period for ‘rehabilitation’ (that is, the repayment period) would normally be three years. This period coincidentally also matched the new (1986 Act) bankruptcy general discharge period.

Since the late 1990s creditor-led procedures and practices, driven by their voting agents, have developed which now set the period of repayment almost without exception at 5–5.5 years (83 per cent of successfully completed cases). They have also changed the decision basis to include the potential but intangible future values of assets held by the debtor and windfalls received during this period.

The most significant element of this last feature relates to equity in the home. The practice has developed—again driven by the creditors’ agents since the late 1990s—for a condition for acceptance to be that a re-mortgage takes place in year 4 or 5 with any available equity released at that time contributing to the arrangement yield. This is a matter that has had no statutory approval or consideration despite the fact that it fundamentally changes the basis of the IVA. This moves the process from a decision mechanism based on present value to one based on future value. Hence it introduces a high level of uncertainty into an otherwise certain process and extends and increases the period of indebtedness.

The research also produced data on the nature of the supply-side providers who administer IVAs. Whilst the IVA market has doubled year on year 2004–06,
and has been frustrated in 2007 and 2008, there has also been a significant operational concentration within a limited number of firms. The growth in the market has been generated by the activities of the top 20 or so firms. Since 1995 the market share captured by the top 20 of the approximately 300 active firms\(^{19}\) has increased from less than 39 per cent to over 85 per cent in the first half of 2008. It is forecast that this will increase further in 2009. There is no evidence that large-scale providers (top 20) either in aggregate or specific groups—that is, top 3; top 10—have a worse early-day failure rate (that is, first 18 months), or indeed overall, than the small providers.

There has also been a significant change over the past four years in the structure of ownership of the principal firms in the IVA market and their range of activities. In the first half of 2008, of the top 13 supply-side providers, covering almost 80 per cent of the market, four are AIM-listed PLCs; a further four started life as major DMP providers; one as a finance house. All 13 firms are now ‘one-stop shops’ providing a range of products such as general advice; DMPs; IVAs; remortgage/debt consolidation; bankruptcy. Ownership is no longer primarily in the hands of insolvency practitioners but has passed to entrepreneurs, recently to a finance house and also to an intermediary in the consumer non-performing debt market, which itself has been bought by a PLC. Mergers and acquisitions of leading houses are now taking place. Change is endemic.

The central issue in relation to IVAs—that of the success of the process—has shown a significant improvement in recent times. In 2002 the aggregate failure rate was of the order of one in three arrangements. This has improved since to a ratio of one in four or five. Of all the new arrangements begun in 2002 only 21.2 per cent had failed by the end of September 2006, the remainder being completed or still ongoing. Early analysis of subsequent years’ data supports this long run improvement.\(^{20}\) This is a longitudinal appraisal, and is ongoing. However, two comments seem pertinent at this stage. First, as a repayment plan it appears to be considerably more successful than those elsewhere, for example the USA and Australia (see Chapter 16), for reasons which are probably due to the socio-economic position and the available monthly contribution levels of the debtors included, and also to the commercial imperative for the provider to ensure successful completion and hence secure cashflow and profitability.\(^{21}\) The second is that the current efforts by creditors’ agents to increase creditor yields at the proposal stage is likely to result in arrangements being written too ‘tightly’—hence future variations will most likely increase, as will the failure rate.

Ongoing research indicates that IVAs are currently used primarily by social classes C and D, representing little change from the earlier research. A prerequisite for an IVA is a minimum monthly payment of approximately £250 and, hence, is largely self-defining. In 2006 these segments covered over

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19 At least one IVA in the calendar year.

20 Anecdotally it would appear that historically ‘non-trading’ IVAs (less than 10 per cent) have a far higher chance of success. Trading (business) IVAs are very problematical.

21 Nothing is known as yet about the reasons for failure: work is ongoing.
two-thirds of all arrangements but only 50 per cent of the UK population. They are families/individuals in work, not those dependent on the state for income or accommodation.

VI. THE UK OVERINDEBTEDNESS REGIME—COMPARATIVE POSITIONING

The UK insolvency regime differs from European systems primarily in its absence of a ‘treatment approach’ to bankruptcy with no formal role for counselling as part of the process. Courts play, as a consequence of deliberate policy, a modest and ever more declining role in England in relation to bankruptcy and repayment plans. England does not have a ‘good faith’ requirement for entry to the regime although reckless conduct and the recognition of the moral hazard may be sanctioned through a Bankruptcy Restriction Order. There is no sequential linkage between the parts of the overall regime. Each mechanism is discrete. The array of available formal mechanisms are based on an increasingly and specifically segmented analysis. Using commercial jargon, they have been ‘products’ targeted at recognised ‘gaps in the market’.

The insolvency regime exists in the context of an ideological preference for a largely unfettered credit market. Debtors are traditionally relatively unprotected and seen increasingly to be responsible for their own choices. However, the Consumer Credit Act 2006 does provide some protection through the new ‘unfair relationship’ test and the inclusion of irresponsible lending as a criterion for a licence revocation. As yet, however, little progress has been made on giving a tangible format to this important concept.22

There is a very well developed array of firms populating the conflict-resolution market and providing advice to those in the working economy and executing arrangements between the debtor and his/her creditors.

Within this overall comparative positioning a subsequent analysis would also demonstrate three points specific to the UK. The first is that the law has no particular prescriptive or coercive purpose or intention in influencing an individual’s pre- or post-bankruptcy behaviour other than in its general public policy purpose of directing a national framework of general commercial morality with its associated sanctions and mechanisms for creditor recovery. Similarly, it is not concerned with extending the period of a debtor’s emotional turmoil once the best economic price that can be paid has been paid or agreed.

The second is that this particular stance should be seen in the context of the further and dominant tenet of government policy and attitude—that of an unfettered credit market. Third, this combination of a ‘law-neutral’ and unfettered credit market operates in a macro-economic context whereby government

policy has deliberately encouraged the expansion of personal borrowings as a major stimulus to the UK economy and where no attempt has been made to curb or dissuade its exponential growth (Table 19.1).

In such circumstances as these and within a credit-dependent and driven economy where the approach to the regulation of the financial sector has been particularly liberal and ‘light touch’, it is perhaps appropriate, therefore, to demand of the state that it recognises the inherent dangers of this position. This standpoint seems to be reflected in the new regime of insolvency and debt repayment which represents the ‘safety net’ designed to combat the consequences of the presence of significant moral hazard, an aggressive credit market, a situation where there are no preventative mechanisms available to minimise or influence the growth of serious overindebtedness and where credit rating procedures ignore and significantly impair the rehabilitation objectives of the legislation.

VII. CONCLUSION

The research highlights the overriding priority of the political dimension of the activity of regime design and change. It also indicates the need for clear articulation of the principles, philosophies and consequential policies and directives which underly any holistic system for dealing with the seriously overindebted. Secondly, the research also suggests that within this political parameter there are a series of fundamental conditions for the existence of effective regime change. First, at the level of the executive, clarity and consistency of political purpose and top level ministerial support. Secondly, the relevant civil service personnel should have substantial technical expertise in this complex area with continuity in tenure over time. At the most senior level they need to have the confidence of, and be well known to, and have a good understanding of, the external participants (that is, lenders, supply-side providers, not-for-profit organisations and so on), and the behaviour, capability and expectations of their related institutions. Observation shows that if betterment and change are to be endemic features of the regime then a locus within a trade-orientated ministry, rather than, say, justice, is desirable.

It is worth noting that the UK programme had its origins in initiatives first approved in late 1999. It will be 2010, at the very earliest, before the entirety of the current programme is put into practice. The very nature of the topic itself,

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23 This approach has historically served the UK well but recent surveillance has not resulted in a system where lenders’ liquidity, the ready determination of exposures and the integrity and opacity of instruments have received their proper weight. Furthermore, historically when lenders have massively miscalculated their book and failed there has been no rescue. The nationalisation of Northern Rock Bank would appear to be a contradiction to this principle: it is suggested, however, that this is a political decision based on unsustainable claims by the Government.

24 A sentiment endorsed by the Cork Report but not acted upon.
and the actors, determine that it is not a policy domain applicable to short-term fixes if prospective results are to be rigorous in concept and defensible in terms of actual outcomes.

Significant differences are observable even within a small geography. England, Wales and Northern Ireland have had the benefit of this particular prescription and progress has been substantial. Scotland has not.25 It has suffered from political misdirection and poor decision making with, consequentially, underused new mechanisms and poor value returns for the expenditures made. The Republic of Ireland has made no changes in recent times despite the transformation of its economy, the expansion of personal credit, escalating levels of debt and bank write-offs. The concepts of relief and rehabilitation are still absent from their current practices and legislation, despite urgings for reform from differing sectional interests.

The third major finding is that any regime considerations must recognise the essential differences between the working and dependent economy. Staggeringly, national regimes as yet do not, nor does the EU approach. Even in the UK, out-with the Insolvency Service, the level of this understanding is poor within government and related institutions, despite voluminous annual overindebtedness plans. The bulk of departmental weight, effort and resources is directed to the dependent economy. Whilst in terms solely of social welfare considerations this is justifiable, in terms of the impact on, and the needs of, the overall economy this present balance is incorrect.

The fourth theme is that of data provision and interpretation. The research demonstrated the dangers of using conventional data sets and analysis in the measurement and description of overindebtedness and particularly in the context of prescription. The macro-economic data generally used is by definition retrospective at worst and indicative at best. Furthermore, the effect of time lags are unknown. Similar comments also apply in respect of debtor-based surveys in terms of their limitations.26 This fundamental weakness in the current and conventional methodology has to be a major concern.

Fifth, the very recent UK experience has demonstrated that in terms of regime design the various mechanisms need to operate within an effective regulatory and organisational format backed by rules, manpower and money. Unless the regime is to be administered entirely by the courts or other public entities, then market behaviour and its elements will need to be monitored and, if necessary, controlled and directed. Without this structure and specific provision, regulatory and market failure will inevitably ensue.

25 It should be said that this is likely to change and new bankruptcy legislation has been enacted but not implemented. A new leading party (SNP) will probably accelerate and broaden the reform process and remove some defects in the current legislative proposals.
26 It is instructive to note that the UK’s powerful and well-represented ‘Overindebtedness Task Force’ found in 2001 and 2003 that overindebtedness was not—nor would be—a serious issue using this narrow and conventional methodology. These conclusions have not proved to be robust.
Finally, it should be reiterated that the essence of a regime is its underlying purpose and philosophies. If these purposes are to be sustained and transformed into everyday flexible practices that are adaptable to change but that maintain the underlying values then the regime and its mechanisms and linkages must be principles based and not rules based. Any deviation from this mantra will inevitably lead to a set of sub-optimal solutions and consequential damage to the best interests of the distressed debtor, the creditor and the state.
Debt Counselling in the Shadow of the Court: The Dutch Experience

NADJA JUNGMANN AND NICK HULS

I. INTRODUCTION

In the Netherlands debtors can clear their debts through two types of procedures.¹ For many years the local debt counselling organisations, such as social welfare service, municipal banks and community social service agencies, have helped debtors to organise voluntary debt settlements in an amicable procedure. Since 1998, administrators carry out debt settlements under supervision of a bankruptcy judge (rechter-commissaris) in a new statutory procedure. The statutory debt settlement (debt rescheduling scheme) is regulated in the Dutch consumer bankruptcy Act (Wet schuldsanering natuurlijke personen, in short Wsnp). The statutory debt settlement differs from ordinary bankruptcy procedure. The main difference is that a personal bankruptcy usually ends in a situation in which there are insufficient funds to repay the creditors but the debtor is still liable to pay remaining debts, but the statutory debt settlement ends in a fresh start.

The Wsnp has three main goals. The first is to offer a fresh start to debtors whose creditors refuse to co-operate to an amicable debt settlement. The second goal is to increase the willingness of creditors to agree to amicable debt settlements (and thereby increase the success rate of local debt counselling). The third goal is to realise a drop in the number of bankruptcies of natural persons (Parliamentary Documents II, 1992/93, 22,969, no 3).

The idea behind the second goal is twofold. First, the legislator believes that amicable debt settlements are a better option for debtors than statutory ones. In the Netherlands there is a strong belief that overindebtedness is often not simply a financial problem, but just one problem in a set of problems. Sometimes debts cause other problems, such as stress between the spouses leading to a divorce or the permanent lack of money with the result that children grow up in

¹ We want to thank Johanna Niemi and Saul Schwartz for their comments on our first draft. We especially thank Saul for helping us to improve the language.
poverty. At other times other problems, such as unemployment, psycho-social problems, addictions or illiteracy cause debts. When debts are seen as a component of a larger problematic situation, solving just the debts is not enough. Debtors need a working method in which they also get other kinds of help to solve all the problems and to prevent recidivism. The Dutch government believes that communities are better capable to offer help to debtors than the courts since the local government not only provides debt counselling but also a lot of other kind of support, for example for psycho-social problems, addictions, poverty and finding work. Therefore debtors and creditors are encouraged to agree to amicable debt settlements. A second and less important reason for the legislator to stimulate creditors to agree to amicable debt settlements is to prevent the courts from getting overloaded with cases. Although a proper cost-benefit analysis was never conducted, the legislator believed that an amicable debt settlement costs less money than a statutory one.

When the Wsnp came into force, local debt counselling successfully helped almost 40 per cent of the debtors asking for assistance. In the following years the success rate dropped, to approximately 10 per cent in 2004. In this Chapter we analyse the way local debt counselling and the courts reacted to the new Act and describe how their reaction negatively influenced the success rate of local debt counselling. Because we think that the Dutch have a different view on overindebtedness than most other countries, we first describe how overindebtedness was in the Netherlands transformed from a private problem into a public issue. We also give an outline of the existing system of amicable and statutory debt counselling. In the next section of this Chapter we describe the decrease of the success rate since 1992 and the way all actors involved in amicable debt settlements reacted to the Wsnp. In the last sections we describe how local debt counselling organisations and courts reacted and we explain why they contributed to the drop of the success rate.

This Chapter is mainly based on the PhD research of Nadja Jungmann.² We use data from eight case studies in eight representative municipalities. In the case studies Jungmann analysed files and interviewed debtors, creditors and employees of local debt settlement organisations. Jungmann analysed 1,200 files from 1997 and 774 from 2000 to find differences between the periods before the Wsnp came into force (1997) and after it came into force (2000). In the files she not only found data on the debtors and their debts, but also about the creditors and their reasons (not) to agree to proposals for a voluntary debt settlement. Because files just give data but no explanations she interviewed 27 employees of the local debt settlement organisations active in the municipalities where she conducted the case studies. She also interviewed 16 managers of these organisations. To find out why creditors refuse co-operation or want to co-operate to a voluntary debt settlement she interviewed 20 creditors face to face. In later

research she also made a survey of almost 200 creditors in a mailed question-
naire. To understand the reasons why debtors ask for help and drop out later,
she interviewed 38 debtors. In all the interviews the main topic was to under-
stand why the success rate dropped after the Wsnp came into force.

II. THE DUTCH SYSTEM: AN ANSWER TO OVERINDEBTEDNESS

For a long time debts have been a private matter, and thus only an issue of
those directly involved: the debtor and the creditor. The Wsnp was the Dutch
response to the emergence of overindebtedness as a contemporary public policy
issue.3

A. From a Private Problem to a Public Issue

A private problem must meet two important criteria in order to become a pub-
lic issue: the problem must occur on a reasonably large scale and have visible
consequences for society. The problem of overindebtedness meets both criteria.
After the Second World War, the Dutch society developed into a welfare state,
in which consumption and credit played an important role. Until the 1960s,
wages were kept low for the purpose of post-war reconstruction. Once the
wages had risen and consumer durables came within the reach of the general
public, the use of credit facilities increased. Since then, the Netherlands has
grown into a society in which overindebtedness became a common phenome-
non. The cause of the overindebtedness was both credit and failure to pay other
creditors, such as landlords and energy suppliers. Overindebtedness occurs
more often in poor households than in middle-class ones, which have more
options to prevent a debt situation from becoming problematic.

However, the scale of a private problem is not always enough to make it a pub-
lic issue; in addition, public attention must also be drawn to the problem.
D’Anjou4 suggests that this is usually done by ‘messengers’ and ‘agents’. In this
case, agents are stakeholders such as municipal banks, social service agencies and
umbrella organisations, such as the Dutch Consumer Credit Counselling Service
(Nationaal instituut voor Budgetvoorlichting or Nibud). Messengers are adva-
ciates who make the public aware of the problem via the media or through politi-
cal channels. These messengers usually get information from agents who can
specify the way in which a private problem has negative impact on public life. The
issue of overindebtedness has been brought to the attention of the public along two
different story-lines: through a socio-economic story and through a legal story.

3 NJH Huls, Make my day; een rechtssociologische herwaardering van faillissementswaarden (Deventer, Kluwer, 1999).
4 LJM D’Anjou, Actoren en factoren in het wetgevingsproces, een empirische theorie over de tot-
standkoming van wetgeving (Deventer, Tjeenk Willink, 1986).
B. The Socio-economic Story in Brief

In 1979 the municipal banks drew up a Debt Rescheduling Code of Conduct (Gedragscode Schuldregeling), which sets out conditions that a voluntary debt settlement must meet. That code was both an initial sign of the problem of overindebtedness and an indication of the direction in which the solution could be sought. Municipal banks in the Netherlands have a social function. They provide loans for people who cannot get money from a commercial bank. In doing so they noticed that more and more people asked for a loan because the commercial banks did not want to give them credit because of existing debts. For them this was the sign that overindebtedness had become a serious problem and that a code of conduct was useful. In the 1980s also other agents, such as Nibud, drew attention to the fact that a growing group of households was struggling with serious financial problems. Research institutes regularly published articles about the causes and consequences of overindebtedness, possible solutions through debt counselling, and the impact of lenders’ aggressive marketing strategies on the steady growth in the number of households with significant financial problems. The media proved receptive to the results of these studies and regularly brought this issue to the attention of the public. One of the effects was that having debts became less of a taboo. It became clear to individual citizens that they were not the only ones with financial problems.

C. The Legal Story in Brief

The core of the legal story is a debate on consumer protection. From the 1960s onwards credit facilities have been booming. Advertisements presented credit as a risk-free activity and as an individual choice. A significant development in this story was the establishment of the Dutch credit bureau, known as the Credit Registration Office (Bureau Kredietregistratie or BKR) in 1964. Lenders established this office to share information about the overall debt burden carried by applicants for new credit. In that period, the legislator also paid attention to prevention through the Dutch Consumer Credit Act (Wet op het consumptief geldkrediet, later amended by the Wet consumentenkrediet or WCK). The former act assumed a division of responsibilities where money was borrowed. Both the individual and the creditor are responsible for the (possible) consequences of the loan.

The two story lines resulted in, on the one hand, the realisation that being overindebted was becoming a more accepted phenomenon, and, on the other hand, the realisation that problematic financial situations became a public issue looking for a solution.

5 JW Segaar, 50 jaren gemeentelijk volskrediet (Almere, NVVK, 1982).
D. The Legal Solution: A Fresh Start

In the 1980s, not only municipal banks but also social services and community social service agencies tried to help debtors. Social services noticed that debtors evicted from their homes, or at whose homes the power supply had been cut off, asked for help and money. Also in their attempts to help people to get work debts played a role. Debtors were not eager to get back to work since all the additional income would go to the creditors. Community social service agencies noticed that an increased number of clients with addictions and other such problems had debts causing so much stress that they could not be helped without solving the debt problem.

Overindebtedness did not prominently feature on the legislative agenda until 1989. In that year the Dutch House of Representatives discussed a bill relating to the garnishment of wages, benefits and other regular payments (Wet beslag loon, sociale uitkeringen en andere periodieke betalingen or Wbleu).\(^6\) The object of this bill was to cancel the inequality between the garnishment of wages and the attachment of benefits. Before the Act became effective benefits under the social security system could not be attached. In practice, this resulted in the situation that the income of an employee earning, say, €900 per month, could be attached, unlike the income of someone living on €900 in benefits. The effect of the legal principle of equality under the Wbleu was intended to result in a fair relationship between creditors and debtors. The bill to make payments under the social security system also susceptible to attachment, was a legal-technical one, and was not challenged politically. However, the bill removed the existing protection of those entitled to social benefits. This gave supporters of a statutory debt settlement the opportunity to get an amendment adopted by a vast majority in the Parliament requesting the Cabinet to develop legislation for overindebted households. The Wsnp is the result of this request.

E. Voluntary Debt Settlements

The idea of the Dutch system is that the amicable and statutory procedures together form one system in which creditors are stimulated to agree to amicable debt settlements.

Voluntary debt settlements are carried out by local debt counselling organisations under the supervision of municipalities. Whenever a debtor asks for help he is called to an intake interview. In that interview the debt counsellor asks what kind of debts the debtor has and for which amount. The debt counsellor also tries to find out whether the debtor has other problems causing or interfering with the overindebtedness. Next, the debt counsellor makes a debt adjustment plan. Such a plan consists of a proposal for a voluntary debt settlement and

\(^6\) Parliamentary Documents II, 1982/83, 17,789.
if necessary for other assistance. A voluntary debt settlement usually takes three years. During the debt settlement the debtor has to pay as much as possible (which means all the money he earns above the social minimum). A small part of the debtor’s repayment capacity (around 10 per cent) is set aside to pay the counsellors for the costs involved in setting up the arrangement. The time it takes to reach an agreement with the creditors depends on the administrative efficiency of the debt counselling organisation and the willingness of creditors to react quickly.7 When the Wsnp was introduced it often took six to nine months before a debtor had an answer as to whether a proposed arrangement was accepted, because some creditors did not give their opinion in less than five or six months.

Between 50 and 75 per cent of all debt counselling organisations follow the above-mentioned NVVK Debt Rescheduling Code of Conduct. The criteria of the Code of Conduct for voluntary debt settlements are that the maximum period is three years, all creditors are treated equally,8 the debtor always has at least the social minimum at her disposal after paying the creditors, and after three years the debtor gets a fresh start by discharge of all remaining debts.

Voluntary debt settlements can take the form of a debt rescheduling (schuldsanering) procedure or debt conciliation (schuldbemiddeling) procedure (definitions from the NVVK’s Debt Rescheduling Code of Conduct). Both procedures offer the debtor a debt-free future, but the methods by which these two forms of arrangement achieve this goal differ.

Debt rescheduling is a scheme under which a package of debts is settled by providing a debt-rescheduling loan. Calculations are made on the basis of the debtor’s income to see how much money can be repaid per month. Based on that information, a debt rescheduling loan is made to the debtor and he has to repay it during the term of the arrangement. The creditors receive payment of their claim (in full or in part) and can archive the debtor’s case file. The debtor’s sole creditor is then the party providing the debt rescheduling loan. Should the debtor’s income go up during the arrangement term, the debtor will benefit from that increase because their loan payments are fixed. If income falls, the debtor has to pay less per month during a longer period.

In a debt conciliation scheme, a calculation is made of the amount a debtor is expected to be able to repay per month and creditors are thus given an indication of the amount that can be repaid under the voluntary arrangement. Based on that information, they are asked to agree to the proposed arrangement. If the

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7 The members of the Dutch Association for Lending to Private Individuals (Nederlandse Vereniging voor Volkskrediet or NVVK) have worked with the so-called 120-day model since 1 January 2004. The aim of this model is to complete the procedure of setting up a debt-rescheduling scheme in no more than 120 days.

8 To treat all creditors equally is something not all debt counselling organisations do. Some organisations give a more favourable treatment or allocate more relative payment to creditors, who reject the plans more often than others. By doing so they ‘buy’ their agreement to a voluntary debt settlement.
debtor’s income goes up during the term of the arrangement, the creditors will be repaid more; recall that in the first kind of arrangement, it was the debtor who benefited from his or her increased income. If it goes down, the amount repaid will be less than budgeted.

F. Statutory Debt Settlement

The system of the statutory debt settlement scheme is similar to that of the voluntary one: the debtor repays all the money he earns above the social minimum. Upon expiry of the scheme, the result is divided among the creditors. Debtors have to request a statutory debt settlement at a District Court. The most important criterion the debtor must meet to be allowed into a statutory debt settlement is that he has acted in good faith (committed no fraud etc). The District Court appoints an administrator and a bankruptcy judge. The main task of the bankruptcy judge is to supervise the progress of the debt rescheduling scheme and the work of the administrator.9

III. THE SUCCESS RATE OF THE AMICABLE PROCEDURES DECREASED

A. Development of the Success Rate in Numbers

The Wsnp was introduced to stimulate creditors to agree more readily to voluntary debt settlements. The legislator intended to influence the behaviour of the creditors by making the statutory debt settlements (financially) less attractive than the voluntary alternative. If successful, the Wsnp should have led to an increase in the success rate of the debt counselling organisations that implement voluntary arrangements. By success rate we mean the share of all requests for voluntary arrangements that result in an arrangement, following an intake interview. We consider the increase in the success rate to be the most important object of the Act. To be clear, we do not define success in terms of the number of cases in which a voluntary debt settlement results in a fresh start. Instead we define success in terms of the number of proposals for voluntary debt settlements that creditors agree to, regardless of the eventual outcomes of the arrangements.

Because of the lack of reliable data, we are unable to accurately describe the national success rate of debt counselling organisations. There are, however, data available to describe the general trend. The NVVK, for example, systematically monitors the number of people that file an application with its members and the number of voluntary debt settlements agreed to. Since its members deal with more than half of all requests for voluntary debt settlements we find the

9 Sections 314 and 317 Fw.
trend representative. In the years after the Wsnp took effect, the success rate dropped from 38 per cent (1997) to 25 per cent (2000) and 14 per cent (2005). The fall in the success rate had started before the adoption of the Wsnp. In 1992 the NVVK members successfully negotiated agreements with more than half (53 per cent) of the debtors. Debt counsellors give as the main explanation for the decrease the rising average amount of money concerned in a debt situation and the number of creditors involved. The more creditors involved, the bigger the chance one refuses to co-operate. And the higher the full amount of money concerned, the less the creditors get during a three-year period, and the bigger the chance they prefer to wait for better financial times for the debtor to come.

On the use of the statutory debt settlement there are exact data. From 1999 to 2005 the number of debtors admitted to a statutory debt settlement increased from 6,528 to 17,780.

Contrary to expectations, after the Wsnp took effect there were no real changes in the downward trend in the success rate for voluntary arrangements that had begun before the implementation of the Act. We wondered: ‘How can this be explained?’ To answer this question we first looked at the reactions of those involved in voluntary and statutory debt settlements.

![Chart 20.2: Statutory debt rescheduling schemes 1999–2005](image)

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11 We have not conducted research that could explain why the success rate increased from 2004 to 2005 from 9 to 14 per cent. We think that the increase is caused by agreements between the NVVK and some big and important creditors like energy suppliers.
B. The Reaction of Actors Involved

The introduction of the Wsnp changed the positions of all those already involved in amicable debt settlements: debtors, creditors and debt counselling organisations.12 The Wsnp gave also the courts a new task.

i. The Debt Counselling Organisations

After the Wsnp took effect, debt counselling organisations were no longer the only providers of debt counselling. Before 1998 they had been the only and last resort for debtors in trouble. That gave them a strong position vis-a-vis creditors. To convince creditors to agree to a proposal for a voluntary debt settlement, the debt counsellors invoked the argument that a debtor otherwise would be unable to pay for years on end, causing the creditors to have to wait for their money for an endless or extremely long time. The Wsnp brought the change that debt counsellors could no longer use this argument, since there is a statutory alternative whenever creditors refuse to co-operate.

In reaction to the new situation many debt counselling organisations adjusted the features of the amicable debt settlements to the features of the statutory ones. The most important adjustment was that debt counsellors lost their discretion to

negotiate with creditors on the individual files. Before the Wsnp came into force debt counsellors could, for example, propose a voluntary debt settlement to take four years if creditors would not agree to the standard of three years. To adjust to statutory debt settlements the maximum period for all voluntary debt settlements is now three years. The NVVK changed their Debt Rescheduling Code of Conduct on this and other points. In all cases the space to negotiate with creditors was ended. In the next section we will explain this point further.

At the municipal level, the Wsnp led many municipal governments to abolish municipal emergency and guarantee funds.13 Long ago, these funds had been set up to maximise the chance of reaching voluntary arrangements. Municipalities have interpreted the Wsnp as a replacement for their responsibility for debtors in problematic financial situations. Therefore, there were fewer options available for tailor-made support of debtors.

ii. The Courts

The introduction of the Wsnp gave the courts a new task. The Wsnp is part of the Dutch Bankruptcy Act. In the Netherlands a regular bankruptcy procedure for a natural person never ends with a fresh start. After all the assets of a debtor were divided amongst the creditors, the bankruptcy is ended. The unpaid debts were then again available for seizure by the creditors. In practice creditors hardly ever file for a bankruptcy of a natural person since it is no real solution for the overindebtedness. The Wsnp meant that a new group of citizens entered the courts: natural persons with high debts and often also other problems causing the debts or interfering with the debts. The courts started their new task very dedicated, but soon after the Act came into force they lost their enthusiasm because they noticed that a pure legal solution is not enough for a lot of debtors to get out of trouble. They also noticed that the statutory debt settlement procedure was very time consuming and not legally interesting.

iii. The Debtors

The position of debtors has been both strengthened and weakened by the Wsnp. From a legal perspective, it has been strengthened, since the refusal by a creditor to agree to co-operate in the implementation of a voluntary arrangement no longer leads to a dead end. For debtors, the possibility of a fresh start through the court has become a sort of empowerment. They can ‘control’ their own future by saying ‘see you in court’ if a creditor refuses to agree. On the other hand, their position has weakened, as debt counselling organisations have limited the room for negotiation in response to the Wsnp, as we stated above.

13 An emergency fund is a fund from which people with debts can be granted a one-time donation to prevent them from being evicted from their home. A guarantee fund is a fund under which the local authority provides guarantees for the debtors, so that they may be granted restructuring credits to clear the debts (where full security of payment is a requirement).
iv. The Creditors

The biggest change for creditors is the fact that they have lost their legal autonomy. Debt settlement is no longer based on voluntary co-operation. The court can order them to co-operate, resulting in the amounts due (or a part thereof) being converted into natural obligations. The legislator hoped that creditors would think that the possibility of being forced to a statutory debt settlement would be such a bad alternative that they agree to an amicable debt settlement more often than before (causing the success rate of local debt counselling organisations to increase). In practice, creditors find the statutory debt settlement an interesting alternative (and being forced to co-operate in a more attractive alternative is no problem at all). They consider a statutory debt settlement as an attractive alternative way of collecting debts: the amounts due are collected by an administrator, while a bankruptcy judge supervises the implementation of the scheme. However, there are also creditors who became more willing to co-operate in amicable solutions or who did not change their position at all. Because of the fact that a single recalcitrant creditor blocks the acceptance of a voluntary arrangement, as long as some creditors become less amenable to voluntary agreements, the net result is likely to be fewer voluntary arrangements.

In 2004 we asked almost 200 creditors why they refuse to co-operate with voluntary debt settlements. The most important answers were that they refused because the local debt counselling hardly negotiates on individual files, statutory debt settlements are (financially) more attractive and they trust the courts more than local debt counselling organisations. In the next two sections we will explain how local debt counselling and trust in the courts contributed to the decrease of the success rate.

IV. ROLE OF DEBT COUNSELLING

One of the remarkable developments surrounding the Wsnp has been the way in which the debt counselling organisations anticipated the effects of the Act. Before we explain how the local debt counselling organisations reacted we first describe three principles of implementation. We argue that local debt counselling organisations shifted from a discretionary to a bureaucratic principle and did not foresee that this change would cause the success rate to drop.

A. Three Principles of Implementation

In the implementation of rules those who execute the rules always have some discretion. It is almost impossible to formulate a policy without using terms that

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14 N Jungmann, NJH Huls, B ter Kuile, Onbekend maakt onbemind, onderzoek naar de overwegingen van crediteuren bij minnelijke schuldregelingsvoorstellen (Almere, NVVK, 2005).
are to some extent undefined and have to be fleshed out in practice. Rules cannot be refined to such an extent that they could be applied unambiguously to any situation that can confront an official implementing them in practice. In the literature on this topic, we can distinguish three implementation principles bearing on the explicit discretionary power that is available to the officials who implement those rules. These principles will be discussed briefly at this point.

With respect to the discretionary implementation principle, the envisaged goal of the rules is more important than uniform implementation. The rules are worded in such a way that officials have discretionary power to act on a case-by-case basis. To be able to make the best decision, officials are expected to have an inner sense of duty which is their guideline in taking decisions. The rules encourage the officials to take decisions in which the context of the individual file is taken into account. Where an adequate inner sense of duty is the guideline, rules based on the discretionary implementation principle can be rather effective. However, there is the risk that the sense of duty will not or will no longer correspond with the view of the policy makers or legislative branch, whereby the discretionary power will become counterproductive and the officials will, in practice, apply their own rules or introduce their own client typologies.

With respect to the professional implementation principle, as well, the envisaged goal of the rule is more important than uniform implementation. Discretionary power in implementation is legitimised by applying a system of standards shared by the professionals involved, in which service and customer satisfaction play an important role. An occupation can be regarded as a profession if there is, among other things, a shared expertise by peer review, training supervised by the profession, a code of conduct or moral code and a professional organisation.

Contrary to the two preceding principles, the aim of the bureaucratic principle is a uniform implementation. When rules are being formulated, an effort is made to define all terms as strictly and in as much detail as possible to minimise discretionary leeway. Supervision and control are key words for the management. Control focuses on the question as to whether the rules are applied accurately. The level to which the implementation leads to the envisaged objectives is less important. The officers implementing the rules are expected to do their work based on impartiality and to ignore any personal considerations.

The three implementation principles have their own advantages and disadvantages. The discretionary and professional principles are most effective when officers work within a complex environment. Such an environment might involve, for instance, a strong differentiation within the client group and/or a wide range of different situations for which clients seek help. In that case, it is difficult, if not impossible, to make an exhaustive list of rules. The amount of

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legislation may also make work difficult. A fourth factor that may complicate work is the situation in which the rules do not concern objective data, such as the level of income, but rather concern social variables such as someone’s efforts to find work. A bureaucratic principle, on the other hand, is the most effective within a rather simple environment.

B. Local Debt Counselling Increased Red Tape

In 1979 the municipal banks drew up their Debt Rescheduling Code of Conduct. The Code was amended in 2000 with the goal of transforming the amicable procedure into a truly uniform prerequisite procedure in line with the Wsnp. The major difference between the two versions of the Code of Conduct is that the principle guiding the implementation of amicable arrangements shifted from the discretionary to the bureaucratic principle.

This change in course can be illustrated by two examples. The first is the deletion of vague terms, such as ‘in principle’ and ‘roughly’ from the text of the Code of Conduct. This change was intended to limit, as much as possible, the discretionary power of the debt counsellors in order to encourage a more uniform implementation of the rules. The second example concerns the scope of the Code. Unlike the current Code, the previous Code of Conduct was not binding upon NVVK members. Under the new version, members that depart from the Code of Conduct can be called into account, and are obliged to explain themselves before a dispute resolution committee. The ultimate remedy for departing from the Code of Conduct is expulsion by the committee. The most important changes are compiled in Table 20.1.17

C. Creditors Reacted to Red Tape

To see what consequences the policy changes in the Code of Conduct had in practice on the implementation of voluntary arrangements, we studied case files at eight different debt counselling organisations. The tightening of the Code of Conduct should result in a greater uniformity in the arrangements made. The case study focused on verifying whether or not that had actually happened. We compared voluntary debt settlements made through the eight organisations in 1997 and in 2000, before and after 1998 when the Wsnp came into force. Four of them were NVVK members during the study and were therefore bound by the new Code upon its implementation. Three of the four non-members had committed themselves to the new Code of Conduct because their management

Table 20.1 Most important differences between the former and the prevailing Code of Conduct

<table>
<thead>
<tr>
<th>Subject</th>
<th>Former Code of Conduct</th>
<th>Prevailing Code of Conduct</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Maximum term of voluntary arrangement</strong></td>
<td>A voluntary arrangement lasts 36 months in principle</td>
<td>A voluntary arrangement lasts no more than 36 months</td>
</tr>
<tr>
<td><strong>Using the entire repayment capacity</strong></td>
<td>Repayment capacity is, in principle, used for the benefit of the creditors</td>
<td>Repayment capacity is used in full for the benefit of the creditors</td>
</tr>
<tr>
<td>(according to calculation method used)</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Check of repayment capacity</strong></td>
<td>During the arrangement, the repayment capacity is rarely checked</td>
<td>The calculated repayment capacity must be checked every year</td>
</tr>
<tr>
<td><strong>Partial resolution of the debt problem</strong></td>
<td>In exceptional cases, a voluntary arrangement need not relate to all debts</td>
<td>A voluntary arrangement always relates to all debts</td>
</tr>
<tr>
<td><strong>Equal adjudication of creditors</strong></td>
<td>Unsecured creditors that have a ‘weapon’ to force the debtor to pay, such as cutting off the power supply or eviction, will be paid as if they are preferential creditors</td>
<td>All creditors get paid in accordance with their legal position under a statutory debt rescheduling scheme</td>
</tr>
<tr>
<td><strong>Assistance given</strong></td>
<td>Each debtor seeking help, and for whom the debt counselling organisation believes that the arrangement can be worthwhile, will be helped</td>
<td>Debtors will only be helped if their debt situation is considered problematic according to the relevant NVVK computation</td>
</tr>
<tr>
<td><strong>Conditional discharge from liability</strong></td>
<td>Pursuant to a conditional discharge clause, creditors could waive the right to discharge upon expiry of the arrangement in cases where the debtor’s income had increased significantly during the scheme</td>
<td>Debtors are always discharged from liability for their debts upon expiry of the arrangement</td>
</tr>
<tr>
<td><strong>Assets</strong></td>
<td>As there are no ways of verifying the absence of any assets, it is not a standard procedure to ask the debtor about assets, such as a savings account or a caravan</td>
<td>The standard procedure is to ask a debtor whether they have any assets</td>
</tr>
</tbody>
</table>
expected it would be a contribution towards the efficiency of the debt counselling service. Only one did not endorse the Code. Apart from studying these files, we also had meetings with debt counsellors, among others. The purpose of these meetings was to map out the arguments for any changes found in the files.

The case files revealed that the voluntary debt settlements made in 1997 by seven of the eight organisations were more varied in terms of the above aspects than those made in 2000. The smaller variation implies more uniformity in the implementation. The counsellors interviewed confirmed this; in their opinion, the main cause of the greater uniformity was the new Code of Conduct. Not all of them appreciated the strictures of the new Code of Conduct; the more limited room for negotiation meant that they could help fewer people. The finding that the success rate was by far the highest at the one organisation that had not endorsed the new Code of Conduct adds to this conclusion. Our conclusion is that the new Code of Conduct limited the space for negotiations, creditors reacted by agreeing less often, and this contributed to the decrease of the success rate. The movement from discretionary to bureaucratic implementation has meant that the strict application of rules has prevailed over making as many voluntary arrangements as possible.

D. Options to Circumvent the Code of Conduct

The debt counsellors held the limitation of their discretionary power as problematic and reacted by developing strategies to circumvent the rules imposed under the new Code of Conduct. The implementation literature mentions four main reasons that may prompt a departure from the official rules: heavy workload, too many rules, poor quality of rules and the speed in which rules are amended. In the interviews, the debt counsellors said that the workload and their personal aim to help as many debtors as possible were the main reasons for their departure from official rules under certain circumstances. Roughly speaking, there are three ways in which implementing officers can circumvent the official rules: (1) not applying rules as prescribed, (2) not applying all rules or (3) applying their own rules alongside the rules prescribed. In the counselling practice, we found all three situations.

i. First Strategy: Not Applying the Prescribed Rules

In daily practice, the accurate application of legislation does not always prove to be the most efficient working method. In organisations where the workload is heavy or where there are waiting lists, the implementing officers often develop

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18 One of the reasons for the fact that in 2000 there were still organisations that made voluntary debt settlements that do not meet the conditions set out in the Code of Conduct is that the Code is only binding upon NVVK members.

19 A Geul, Beleid in uitvoering, Problemen en remedies (Utrecht, Lemma, 2002).
unofficial working methods that can be referred to as *smart rules*. They develop ‘procedural lubricants’. One rule which is circumvented by adding ‘a procedural lubricant’ is the writing of letters to the creditors. Previously, all creditors got a proposal. If any one of them (or several of them) withheld their agreement, negotiations were delayed by the attempt to win them over. As there is no room for negotiation any more, some of the debt counsellors would only send letters to those creditors whom they thought were likely to withhold their agreement. As soon as one of them did so, the file would be closed, since it would now be clear that not all creditors were prepared to agree to the proposal. Considering that debtors had in 2000 on average nine different creditors, it becomes immediately clear that this *smart rule*—to send a letter only to a potentially ‘refusing’ creditor—saved a great deal of work, compared to the *proper rule* which entails sending letters to *all* creditors. Because of this circumvention debt counsellors do not know how many creditors refuse to co-operate. They only know that at least one of them refuses. In practice, if you know only one out of nine creditors refuses, you can often talk the only one into co-operation when you explain that he is the only one refusing. The circumvention to send a letter only to one creditor at a time saves time, but also prevents using the overall view to persuade reluctant creditors to agree.

A second example of such a *smart rule* is the informal refusal of debtors. The former Code of Conduct stated that a debtor must be helped if the debt counsellor, having roughly analysed the situation, sees a possibility to solve the problem. At the time, debt counsellors had the discretionary power to decide on a case-by-case basis whether or not it was worth making the effort. According to the debt counsellors interviewed, nobody was really ever sent away. This is also the reason why we found considerably more arrangements that resulted in fully paying off the debts in the 1997 case study than in the 2000 one. Debt counsellors currently attempt to assess, during the first contact, whether or not someone’s situation will be considered problematic according to the NVVK computation. If this is not the case, the debtor will be discouraged from officially filing an application. That means that the debt counsellor can avoid doing the initial interview for debtors who will not be eligible for assistance.

It is true that this *smart rule* reduces the amount of work that the debt counsellors have to do, but it may also have a negative impact on the success rate of debt counselling organisations. By introducing the NVVK computation, the change in client population went unnoticed. People with a relatively small debt compared to their income are no longer eligible for assistance. They are precisely the group that always and most frequently used to be helped. In general, the chance of a voluntary arrangement being reached decreases as the percentage of the amounts due that is repaid falls. An unintended effect of this *smart rule* could thus be that the drop in success rate seems to be more serious than it really is. This is important; debt counsellors confirmed that one of the reasons for the decrease of the success rate is that cases are now more difficult than before.
ii. Second Strategy: Not Applying All the Rules

An alternative strategy is not to apply all the prevailing rules. Under the former Code of Conduct, debt counsellors were not expected to ask debtors, as a standard question, whether or not they had any capital assets such as motor vehicles or savings accounts. Under the new Code, they are obliged to do so. As debt counsellors have no authority to check the accuracy of the answers, they often avoid asking for this information. By leaving the box of the initial interview form blank, it is not clear whether the subject of ‘assets’ has been addressed during the interview. The debt counsellors interviewed said that they do not always address this subject.

iii. Third Strategy: Applying One’s Own Rules

Another alternative strategy is to create rules of one’s own. For example, the debt counsellors instruct debtors to ask the bank for a document with the status20 of their debt situation from the Credit Registration Office and hand that in at the next appointment. If the debtor does not make the effort to go to the bank, they see it as an indication that the debtor is not motivated to act to get a fresh start. This is a reason to refuse further help because they avoid spending time on a case in which a voluntary debt settlement will never be reached because the debtor does not co-operate. (The fact that some debtors do not make the effort to go to the bank because they find the form which they need to use to get the document too complicated, is not taken into account by the debt counsellors.)

We can conclude from the results of our case studies that the goal of the uniform implementation practice has been achieved to a large extent. However, there is an unforeseen downside. For both creditors and debtors, the higher level of red tape means that there is less room for negotiations. It is no longer possible to take into account the circumstances of the specific case when proposing a voluntary debt settlement. The reports in the files show that this is one reason for some of the creditors and debtors to withhold their agreement to a voluntary arrangement. Consequently, the advantage in terms of uniformity has contributed to a drop in the success rate. This conclusion is corroborated by the fact that the only organisation studied, in which the rules and the implementation principle had not changed, had by far the highest success rate.

V. CREDITORS PREFER GOING TO COURT

For a creditor, the choice between a voluntary debt settlement and a statutory one is based on several considerations. We will discuss two important ones here: the advantages of statutory debt settlements and the image of the court.

20 The document gives insight into the amount of money they have loaned, the amount of money they are behind in repaying and the name of the financial institutions who have lent money to the individual.
A. Advantages of Statutory Debt Settlements

Creditors have a number of reasons to prefer statutory debt settlements over voluntary debt settlements:

- in the statutory debt settlements more relevant information becomes known than in voluntary ones;
- the fulfilment of the statutory debt settlements is more burdensome to debtors and if they drop out the creditors can attach the wages again;
- shame about overindebtedness is sometimes a reason that the debtor does not file for a statutory debt settlement, which gives the creditors the possibility to continue to attach the wages;
- for creditors it is not clear in which cases a voluntary debt settlement is financially more attractive;
- for creditors a statutory debt settlement is less time-consuming and thereby less expensive than a voluntary debt settlement;
- creditors think of a statutory debt settlement as a punishment for the debtor;
- legal obstacles hinder creditors from agreeing to voluntary settlements.

i. Relevant Information

In a statutory debt settlement the creditor has more certainty about the debtor’s situation than in a voluntary debt settlement. In a voluntary debt settlement the only available information is what the debtor provides. To check, for example, a debtor’s income most organisations require the debtor to present bank statements over the past three months. The debt counsellors require that the debtors show documents about assets, such as savings account balances. Assets that are not revealed by such statements are not known to the debt counselling organisation unless debtors reveal them at their own initiative. In a statutory debt settlement the administrator visits the debtor at home to see whether there are costly things to sell, and the administrator receives all the mail to check whether the debtor has savings accounts, motor vehicles or other items to sell. These provide creditors with more insight into the debtor’s actual situation.21 Because of the imbalance in information between creditors and the debtor in voluntary arrangements, creditors often prefer the statutory procedure.

ii. Drop-out Because of Burdensome Procedure

The drop-out risk is another consideration. For debtors, a statutory debt settlement is a burdensome ordeal. If the debtor does not fulfil the conditions, the scheme is terminated early and the debts not repaid will continue to burden the

21 A similar consideration is applicable when debtors say that they can no longer pay their creditors. The reasons put forward by debtors for non-payment cannot be assessed by creditors, because almost every relevant piece of information is in the debtors’ hands.
debtor. Because there are insufficient funds, the creditors will be unable to collect a large amount at once, but the income of the debtor can be attached again and small amounts will keep on coming in.

**iii. Debtors are Ashamed of their Debts**

Many debtors feel ashamed of their debts. Many of them perceive the experience of their mail being redirected, and (formerly) their name being published under a statutory debt rescheduling scheme, as extremely trying and incriminating. Some debtors refuse to rely on the Wsnp because they feel embarrassed. Some creditors refuse to agree to a voluntary arrangement, because they think that the debtor is not likely to resort to court. In that case, they can maintain the debt collection measures. The creditors that make their decision on the basis of this consideration expect that a long-term attachment will yield more than a three-year voluntary debt settlement.

**iv. The Financial Difference between Voluntary and Statutory Debt Settlements is not Clear**

The Dutch legislator wanted voluntary debt settlements to be financially more attractive than the statutory ones to encourage creditors to agree to the former. Therefore the administrator gets in every statutory debt settlement a small amount of the money the debtor pays monthly. In 2007 an administrator received about €50 each month. While drafting the Act, it seems that the legislator did not know that in voluntary debt settlements the debt counselling organisations get a percentage of the money the debtor pays. In most cases the percentage varies between 9 and 14 per cent. As a consequence, the voluntary settlements are more attractive only when the debtor pays monthly less than €500 to the creditors. When the debtor pays over €500 per month, the statutory debt settlements are financially more attractive. Because the creditors do not know in advance how big the payments are going to be, the other reasons for creditors to prefer statutory debt settlements are in many cases more important than the financial difference.

**v. Statutory Debt Settlements are Less Time-consuming**

For creditors a statutory debt settlement is less time-consuming. The debt counselling organisations have different working methods. Agreeing to a voluntary debt settlement requires that the creditors control whether the implementation is of sufficient quality. By saying ‘no’ to a voluntary arrangement, the creditors

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23 The state pays the rest of the salaries of the administrators.
can save the cost of monitoring the debt counselling organisations and the arrangements made. Under the Wsnp, this cost is largely covered by others, as the state pays most of the salaries of the administrators and court officers.

vi. Creditors Want to Punish the Debtor with the Hardest Procedure

Finally, there are also totally different considerations. Some creditors feel that debtors deserve to be punished for their behaviour. For debtors, a statutory debt rescheduling scheme is more of a burden than a voluntary arrangement. Their mail is sent to the administrator. The supervision of the administrator, and the obligation to obtain permission for specific transactions, are considered a greater burden than the implementation of the voluntary arrangements. The same goes for the publication of the debtor’s name in the Government Gazette. There are creditors who refuse to agree to voluntary arrangements in order to ‘punish’ the debtor by forcing a statutory scheme upon them.

vii. Creditors are not Allowed to Agree to a Voluntary Debt Settlement

A last but important reason for creditors not to agree is that they are not allowed to do so because of their legal position. Organisations such as social services, the National Social Institute (Landelijk instituut sociale verzekeringen or Lisv) and the Social Insurance Bank (Sociale verzekeringbank or Svb) must abide by the statutory framework, which is an obstacle to agreeing to a proposal for a voluntary debt settlement.

B. The Image of the Court

Debt counselling organisations came into being thanks to self-regulation. As described in the second section municipal banks were the first ones to offer debt counselling. The social services and social welfare institutions got involved in the 1980s when debts turned out to be an obstacle for their core business of supporting people to find jobs and of providing psycho-social counselling. All three types of organisations initially advocated on behalf of their clients. They presented themselves to creditors as the representative of the debtor on whose behalf they made proposals for voluntary arrangements. This position was visible, among other things, in their letters to creditors, in which they explained the personal situation of the debtor.

Over the past few years, most debt counselling organisations have presented themselves as independent and neutral agents. However, many creditors still see debt counsellors as the agents of the debtors. As a consequence to many creditors the courts meet the necessary condition of impartiality far more easily than the debt counselling organisations. For some of the creditors, this is a very important argument in favour of statutory debt settlements.
The effect of creditors having more faith in the courts is interesting for the judiciary. The neutral position of the judiciary has proved to be one of the causes of the growing number of statutory debt settlements, which the judiciary sees as an undesirable effect. The increase in the number of statutory debt settlements and the workload of the judiciary was the main reason for the courts to ask the Minister of Justice in 2003 to change the Wsnp in such a way that their workload would decrease. Trust in the judiciary is very important, but it had not occurred to the legislator that it would lead to such a big caseload for judges that they would ask the Minister to act.
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