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The EU Social Protection
and Social Inclusion Process

Policy Studies Findings – 11

Towards a common operational European definition of over-indebtedness

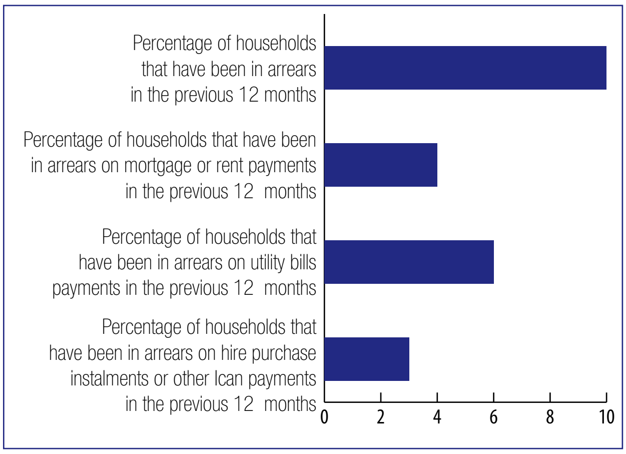
With the expansion of access to credit and the provision of new products in financial services, consumer over-indebtedness is increasingly moving into the focus of the European public. Yet, so far there has not been a standard definition of over-indebtedness which is accepted throughout the Union. This is one of the reasons why there are no comparable statistics about the current state, extent and past development of over-indebtedness within individual Member States. Such a lack hampers the evaluation of policy measures and undermines any well-founded discussion about the effectiveness of prevention measures.

This is the background against which the European Commission arranged for a study by three partners: the Observatoire de l'épargne européenne (Paris, France), the University of Bristol, Personal Finance Research Centre (United Kingdom) and the Centre for European Policy Studies (Brussels, Belgium).

The objectives of the study were threefold:
- *To identify the nature and causes of over-indebtedness.*
- *To review the definitions and measurement of over-indebtedness and to propose common definitions and indicators.*
- *To provide an overview of the debate and policies to tackle over-indebtedness.*

Financial difficulties of European households

Analysis of Eurobarometer data shows that 13% of households across EU Member States had difficulties meeting credit and other household commitments in 2006. The European Survey of Income and Living Conditions (EU-SILC) data for 2005 shows that experience of arrears was slightly less common, although 10% of households had still been in arrears on at least one payment in the previous 12 months.



Source: EU-SILC 2005

The level of difficulties tended to be lowest in Northern Europe (especially in Scandinavia and the Benelux countries); it was highest in Eastern and Southern Europe. The exceptions were the Czech Republic, Estonia and Slovenia where the levels of reported financial difficulties were below the EU average. Countries with the lowest reported levels of financial difficulty were the ones with high levels of overall wealth (GDP per capita) and low levels of income inequality. Conversely, financial difficulties were most prevalent in countries where incomes were low and income inequality was high.

European Commission

Nature and causes of over-indebtedness

Research has consistently shown that both **personal characteristics** (being young, single and having children) and **economic circumstances** (low income, economic inactivity and renting a home) have strong associations with the likelihood of being in financial difficulties. Various aspects of money management are also important, including: attitudes towards money management and paying bills; attitudes towards spending; the use of unsecured credit; and the possession of savings.

Existing research also provides a consistent picture of the **reasons why households get into financial difficulties**: persistent low income and adverse financial shocks, as well as over-borrowing and poor money management. The balance between these varies over time, depending on levels of economic prosperity. Moreover, as with most complex social phenomena, there is not a single simple cause of over-indebtedness. Risk factors (such as low income) will work in combination with each other and with triggers (change in circumstances) in leading to over-indebtedness. Poor money management and over-commitment will tend to compound the problems faced.

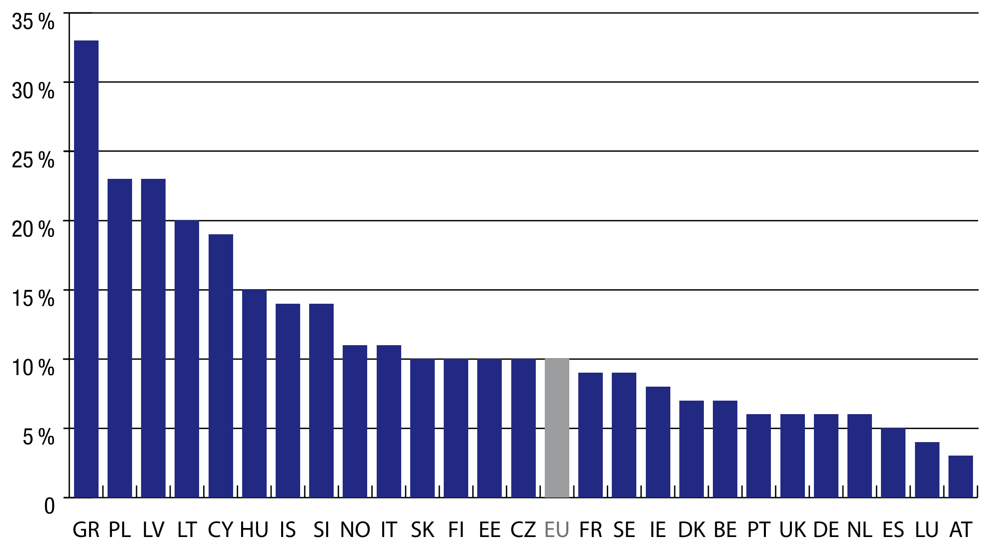
Definitions of over-indebtedness

The study provides an overview of definitions and measurements of financial difficulties and over-indebtedness in the 19 European countries reviewed. These countries are: Austria, Belgium, Bulgaria, the Czech Republic, Finland, France, Germany, Greece, Ireland, Italy, Lithuania, Luxembourg, the Netherlands, Norway, Poland, Portugal, Spain, Sweden and the United Kingdom.

The study has intensively reviewed a number of definitions used at the European level as well as within individual Member States. Therefore, definitions provided by both public bodies (such as governments) as well as by private sources (such as consultancy firms and academics) have been analysed. There is no uniquely acknowledged definition and the concepts vary across countries. This is perhaps a reflection of the complexity of the issue itself. However, a number of underlying and common elements that are used by many of those definitions have been identified, and these can serve as a common foundation.

So far, over-indebtedness has not been defined at the European level. For illustrative purposes, some examples present in the public debate

Percentage of households that have been in arrears in the previous 12 months



Source: EU-SILC 2005

were identified. For instance, the Group of Specialists for Legal Solutions to Debt Problems at the European Council (CJ-S-DEBT) states that over-indebtedness is a changing concept, which can cover at one and the same time problems with both *credit commitments* and *difficulties with day-to-day bills.* For the purpose of the CJ-S-DEBT Recommendation1, over-indebtedness means, but is not limited to, the situation where the debt burden of an individual or a family manifestly and on a long-term basis exceeds the payment capacity[2].

In Germany, the Federal Family Ministry states that: “A private household is over-indebted if its income is not sufficient for servicing debt on time (after accounting for the costs of living expenses) over a longer period”.

Some governments in Europe have started to use definitions but they often apply different approaches. For instance, economic definitions are used by the governments in Austria and Belgium (where households are seen as over-committed if, after deduction of living expenses, they cannot satisfy all payment obligations). Luxembourg’s definition is similar to Belgium’s. Further variations exist in the public discussions in France, Ireland, Sweden, The Netherlands, Portugal, and Norway. Finally, no definitions were identified for Lithuania, Bulgaria, the Czech Republic, Italy, Spain and Greece**.**

Proposed foundations for a European definition

The review of existing definitions showed that many of them contained some common elements. For instance, the unit of measurement is in most cases the household (in other cases the individual or debtor). About half of the definitions reviewed make a reference to time (such as long-term or structural problems), many definitions include debt or contractual financial obligations. Furthermore, about half of the definitions include a reference to cost of living expenses. Most of the definitions refer to payment capacity, such as the inability to pay the contracted obligations.

1 Recommendation CM/Rec(2007)8 of the Committee of Ministers to Member States on legal solutions to debt problems (Adopted by the Committee of Ministers on 20 June 2007 at the 999bis meeting of the Ministers’ Deputies).

2 A later definition by ORC Macro (2001) proposed a subjective definition, based upon households that report financial difficulties.

The most important elements of a common operational definition of over-indebtedness

Household. Households are the relevant unit for quantifying over-indebtedness. The authors use the well-accepted definition of households as small groups of persons (or one person) who share the same living accommodation, who pool some, or all, of their income and wealth[1].

Contractual financial commitments. All contractual financial commitments are included, among them mortgage and consumer credit commitments, utility and telephone bills as well as rent payments (recurring expenses). Informal commitments entered into within families, for instance, are excluded as limited data exists on them.

Payment capacity. Over-indebted households are unable to meet the expenses associated with the contractual financial commitments and recurring expenses.

Structural basis. This is the time dimension, which holds that the definition must capture persistent and ongoing financial problems and exclude one-off occurrences that arise due to forgetfulness, for instance.

Standard of living. The household must be unable to meet contractual commitments without reducing its minimum standard of living expenses.

Illiquidity. The household is unable to remedy the situation by recourse to (financial and non-financial) assets.

1 This definition is derived from the European System of Accounts ESA 95 methodology.

Over-indebtedness measurements

Over-indebtedness is a complex, multi-dimensional problem which might not be easily measured by using just a single indicator.

The following types of indicators have been identified:

- Statistics on arrears (such as on mortgages, financial commitments, unsecured credit/loans),
- Statistics on debt settlement (court-arranged solutions to debt, people assisted with repayment plans by debt advice agencies, debt write-offs by creditors),
- Surveys with assessments by households of their financial burden (with regard to over-indebtedness or amount owed), and
- Other (borrowing-income ratio, debt-service burden, users of debt advice agencies).

Existing data and meta-data relating to over-indebtedness in the 19 countries reviewed have been organised according to the above classification and stored in a structured database.

It is important to acknowledge that in the Open Method of Coordination, indicators must measure the **effects of policy measures and not the measures themselves** (as the choice of policy measures is left to the discretion of Member States).

The **European System of Central Banks** typically uses a number of indicators to measure the "financial fragility of the household sector". Such measures are macro-economic in nature and not suitable for identifying over-committed households.

There are also a number of closely related **indicators from private sources** such as Schufa Holding AG in Germany (Private Indebtedness Index) and Experian in the UK (Affordability Index). Essentially, as credit scoring is the prediction of a consumer's individual risk of default, it might also qualify as measurement of over-indebtedness risk.

Many indicators do not exist in a number of countries (such as financial obligation ratios), while others might exist (such as arrears), but might be differently defined. We have reviewed the above indicators and made a judgement based on the following criteria: information content, reliability, comparability, frequency, coverage and usage of the measurements. This evaluation showed that there is a large variation among indicators. The main problem is coverage – not all indicators are available in all countries and the underlying concept can vary. For instance, there are different bankruptcy procedures in the Member States, thus bankruptcy is not easily comparable (considering the Open Method of Coordination as explained above, this indicator cannot be proposed as measurement). While there is greater coverage in terms of people in financial arrears, the concept of "financial arrears" is not the same across countries. Debt-service ratios, on the other hand, are not collected in all Member States, although the definition does not vary much.

Developing a common method of measurement

From a statistical point of view, deriving indicators from different sources in more than one country poses problems such as variations in availability, accessibility, coverage, measurement and reference periods. Based upon intensive review and evaluation, the Consortium therefore proposes to use the EU-SILC survey.

The EU-SILC is a cross-sectional and longitudinal multi-dimensional micro-data annual survey on income, poverty, social exclusion and living conditions of a panel of households. Regulation No. 215/2007 of 28 February 2007 established a list of "secondary variables" to introduce a special module on over-indebtedness and financial exclusion of the EU-SILC. This is a one-off module. In the regular survey, there are already a number of questions which can be used to monitor over-indebtedness. It would be desirable from a statistical point of view to concentrate on the regular EU-SILC survey and use the special module for further research.

In order to evaluate the number of over-indebted households, the authors propose that **a household should be considered as over-indebted if it meets these criteria:**

- Comparably high commitment payments which push the household below the poverty-threshold.
- Structural arrears on at least one financial commitment (this includes all types of credit commitments, but also other recurring bills such as utilities, etc).
- Burden of monthly commitment payments (housing costs including mortgage payment or rent and payment for other loans) considered to be a heavy burden by the household.
- Payment capacity considered to be 'very difficult' or 'difficult' by the household, and
- Illiquidity (an inability to meet an unexpected expense).

Being at risk of over-indebtedness could be defined as a household that meets the last four of the above criteria; the income is not reduced below the poverty threshold by the recurring commitment burden each month, although it is approaching it (or, alternatively, it is approaching the monthly minimum costs of living of that household).

Households in financial difficulties could be measured by using the aggregate number of households that fulfil the above criteria, except for approaching the poverty threshold (or, alternatively, approaching the monthly minimum costs of living of that household).

The study defines additional questions to add to the EU-SILC questionnaire in order to identify and number over-indebted households.

Measures to prevent over-indebtedness

Measures to prevent over-indebtedness are needed in three broad areas: responsible borrowing and money management; responsible lending; and responsible arrears management and debt recovery.

Responsible borrowing and money management

It is widely acknowledged that some consumers do not have the skills necessary to manage their finances and make informed decisions. A Communication on Financial Education[3] adopted by the European Commission on the 18 December 2007 stresses the importance of good financial education as a way of enabling consumer awareness of risks and opportunities and helping them make informed decisions. Responsible borrowing and money management is addressed through a **mixture of information, education and advice. Information provision** has typically been related to general financial capability skills such as budgeting, but there has also been discussion of the benefits of giving personalised information to consumers when they apply for credit. None of the countries studied has a single provider of preventative education: all rely on delivery from a number of organisations. Some pan-European provision is available however, such as DOLCETA, an online financial education system for adults.

Providing financial education in schools ensures that young people receive training before they become active consumers. Although few countries have a national financial education curriculum, schools do provide some level of **financial education in most countries**. This is either taught by subject teachers through various aspects of the curriculum or through external partners (such as Citibank in Bulgaria or Schufa Holding AG in Germany).

Where responsible borrowing and money management skills are encouraged amongst adults, the impetus often comes from consumer organisations.

However, there is also ad hoc provision in various countries by providers ranging from not-for-profit organisations, through to financial services institutions and credit reporting agencies.

3 COM(2007)808final
http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:52007DC0808:EN:HTML

Strategies aimed at preventing over-indebtedness through information and education tends to focus on **developing money management skills** such as recording expenditure and budgeting. More developed strategies also recognise the importance of other aspects of financial capability, such as encouraging saving in order to protect against future changes in circumstances, and explaining the benefits of insurance.

Responsible lending

Most of the countries studied have legislation or codes of practice related to responsible lending, but their nature varies and includes credit reporting and interest rate ceilings.

Initiatives requiring lenders to make extensive checks of a borrower's ability to pay before issuing credit seem likely to provide the most responsive protection for consumers and to carry a lower risk of financial exclusion. To date, these have been achieved through legislation or self-regulation. Some provisions can also be found in the new proposal of the EC Consumer Credit Directive[4] (May 2007 version), where the concept of responsible lending can now be found in a modified Article 7a. This states that prior to the conclusion of the credit agreement, the creditor shall assess the consumer's creditworthiness "on the basis of sufficient information, where appropriate obtained from the consumer and, where necessary, on the basis of a consultation of the relevant database."

The nature of penalties and sanctions for non-compliance will be left to Member States, but experience shows that they are most effective if courts have the power to re-open credit agreements if inadequate checks have been made. Removal of credit licenses could be appropriate in cases of serious and repeated violations of the law. Experience also shows that compliance should be carefully and continuously monitored by an independent body.

Credit reporting is an important mechanism to further expand credit risk assessment. The potential for improvement in the effectiveness of credit reporting through the use of positive as well as negative information is a contentious issue. The role of increased credit data sharing and the extension of reporting beyond consumer credit commitments (e.g. to include utilities and rent) are also subject to debate.

4 COM(2002)443final – for texts and procedure see
http://ec.europa.eu/prelex/detail_dossier_real.cfm?CL=en&DosId=176090

Debate around legislation to set **interest rate ceilings** tends to be emotive. While there is a strong moral argument for protecting consumers against excessive charges, it can also be argued that ceilings distort markets and can contribute to financial exclusion. The desirability of a rate ceiling depends on three main factors: whether a ceiling already exists; the maturity of the credit market and whether there is national provision of (subsidised) affordable credit for high-risk consumers, for whom the cost of credit is high. For these reasons, decisions are best made by individual Member States.

Useful models of the provision of affordable credit include: the funds established in Italy to assist victims and potential victims of exploitative lending; the Irish Money Advice and Budgeting Service; the Municipal Banks in the Netherlands, and initiatives in the UK to develop not-for-profit lenders and to tackle illegal lending.

Responsible arrears management

It is in the creditor's interests to take a pro-active approach to arrears management, beginning early in the process to promote arrears avoidance (for example, by providing appropriate and frequent payment methods). Contact with defaulters at the first sign of arrears facilitates the early recovery of missed payments. As such, creditors need to have in place procedures and systems that are sufficiently flexible for dealing with defaulting customers (or those at risk of defaulting) on an individual basis. Once arrears are entrenched, it is necessary for creditors to engage with customers about their ability to repay and negotiate with them – preferably in liaison with a debt advisor – a realistic repayment plan, and to tolerate some degree of forbearance.

The vehicle through which provisions for good practice in arrears management are determined is less important than ensuring that these provisions are complied with, which requires mechanisms for monitoring and enforcement. Indeed, the industry can self-regulate. Compliance with the spirit – rather than the letter – of the provisions makes for a more effective approach and a greater chance of recovery of the money owed.

Given that arrears will normally arise because of financial difficulties, court action and debt recovery are best seen as last resorts and pursued only on a selective basis. As recommended by the recent Council of Europe recommendation[5] and report on legal solutions to debt problems, the activities of extra-judicial debt recovery agencies should be delimited. It advocates that the legitimate interests of the creditors should be balanced with the protection of the dignity and essential assets of the debtor, regardless of any outstanding debts, thereby ensuring the minimum living standards of the debt.

Measures to alleviate over-indebtedness and rehabilitate debtors

A comprehensive approach to tackling over-indebtedness also requires three groups of measures to assist people who are seriously over-indebted and to rehabilitate them: debt advice and counselling services; judicial processes, including bankruptcy; and non-judicial (or amicable) procedures for debt settlement.

Debt advice and counselling services

The provision of debt counselling for over-indebted consumers is common in Europe, although it is better developed in some countries than others.

While the primary focus tends to be the resolution of financial difficulties, it may also try to help consumers avoid further difficulties by providing guidance on money management and budgeting. In some countries, debt counsellors help consumers to access related services, usually through partnerships with other organisations. In Ireland, for example, the Money Advice and Budgeting Service may refer consumers to a credit union to access debt repayment and bill repayment facilities. Debt counselling is generally provided free of charge by not-for-profit organisations or public institutions.

Municipalities are often involved in the provision of debt counselling services; in Finland, Norway and Sweden there is a legal obligation to ensure over-committed consumers can access them.

5 Recommendation CM/Rec(2007)8 of the Committee of Ministers to Member States on legal solutions to debt problems.

Debt counselling services have to be **adequately resourced** in order to meet demand in a timely manner and to provide comprehensive geographical coverage – something that is lacking in many countries, even those that have networks of debt counsellors. **'Umbrella' organisations** seem to be important, for example in promoting consistent standards, providing information, training and supporting debt counsellors and representing the interests of debt counselling organisations at a strategic and political level. Linked to this, **a robust system of certification or accreditation** for debt counsellors should help to ensure that consumers receive consistent, high-quality advice and assistance.

Judicial processes, including bankruptcy

A number of countries have introduced judicial processes to achieve debt settlement including Austria, Belgium, Finland, France, Germany, the Netherlands, Norway, Sweden and the UK. Similar procedures will be introduced in the Czech Republic in 2008. Where introduced, debt settlement procedures have played a major role in tackling over-indebtedness in a humane and efficient way. The main criticism is that they are often inefficient in rehabilitation of the debtor or in the prevention of future financial difficulties. Where countries lack legislation of this kind, outcomes of court hearings tend to be harsh.

Analysis of these initiatives has identified the following **key factors** for a successful scheme: unrestricted access (except in cases of fraud); compulsion on lenders to participate; realistic payment levels that leave the debtor with income for an adequate standard of living; and time limits on the payment plan. Ideally, there should also be a link to a programme of assistance with money management and budgeting to help with rehabilitation and to prevent further problems.

Bankruptcy provisions are an important part of a comprehensive approach to over-indebtedness and have been introduced for individuals in most of the countries studied, the exceptions being Greece, Italy and Lithuania. In Poland legislation is planned. Bankruptcy laws for individuals have recently come into force in Portugal (March 2004), Spain (September 2004), and Czech Republic (January 2008).

Non-judicial procedures for debt settlement

In reforming their court processes, a number of countries have introduced non-judicial procedures for dealing with debts in a holistic way. Although they operate in slightly different ways, they too have played a major role in the resolution of over-indebtedness problems faced by individuals. Most importantly, they enable cases to be resolved without the additional costs of a court hearing or the adverse record of a court judgment at credit reporting agencies. Again the main criticism would be the lack of a link to help in avoiding further problems in future. The key ingredients of success are similar to those for judicial procedures

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Further information

A copy of the full report can be found on the European Commission website Social Protection-Social Inclusion:

http://ec.europa.eu/employment_social/spsi/studies_en.htm#overindebtedness

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