Research Report

# Two Dimensions of Combating Over-Indebtedness

## Consumer protection and financial stability

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European Credit Research Institute

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**Abstract**

The expansion of credit markets has fostered economic growth across the European Union, but it has also produced a sharp increase in the average level of household indebtedness. As a consequence of the financial crisis, the drop in households' disposable income has undermined the ability of many EU households to honour their financial commitments. Against this background, this paper investigates the complexity of indebtedness and draws a distinction between its legal and economic dimensions in order to better understand the phenomenon. Despite efforts made by the European Commission, we found that the definition of indebtedness and over-indebtedness still lacks precision. Mirroring the interventions of national legislators in terms of consumer protection, over-indebtedness in the EU tends to be narrowly defined in terms of its relationship with insolvency. Therefore, further efforts need to be taken in designing the necessary measures to alleviate and prevent over-indebtedness. Accordingly, this study focuses on the role of financial education, analyses the impact of the relevant EU directives, collects important evidence in support of harmonising debt-advice services and explores the path towards a common methodology of *early detection of vulnerable households.*

The **European Credit Research Institute (ECRI)** is a research institution that operates within the Centre for European Policy Studies (CEPS) in Brussels. Established in 1999 for the study of banking and credit in Europe, ECRI focuses on institutional, economic and legal aspects related to retail finance and credit reporting. The institute provides expert analysis and academic research for a better understanding of the economic and social impact of credit. ECRI supports and funds independent academic research projects. The institute monitors markets and regulatory changes and looks at their impact nationally and internationally.

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# Introduction

Between 1998 and 2007, the European credit market has registered an unprecedented expansion, which has significantly contributed to economic growth in the EU. This development has been particularly pronounced in the household sector, namely for consumer and housing loans. Accordingly, while in 1998, the total borrowing capacity of households represented 42.1% of the total GDP in the EU, this share increased to 57.8% in 2007. More flexible conditions for credit market access have sustained consumption and investments by European households, impacting positively on their social and economic situation.

Financial integration and the adoption of a single currency are two major factors at the root of this remarkable expansion across all the EU member states. The unification of official interest rates, indeed, produced a meaningful drop in the real borrowing cost for households in many countries in the EU, spurring a significant rise in credit demand. At the micro-level, the expansion of credit markets has fostered an increase in home ownership rate throughout the EU member states, and made higher education more affordable across all income classes. The mitigation of credit access conditions has promoted housing renovation, contributing thereby to the protection of Europe’s cultural heritage and the preservation of European real estate. Finally, credit markets have played an important role in the on-going energy transition towards low-carbon technologies both at households’ level and at the broad-country level.

However, such an expansion in the outstanding households’ debt has concealed two major risks. The drop in real interest rates has created the conditions for asset bubbles, as has been registered in the housing market especially in Spain and Ireland. At the same time, the increasing borrowing capacity has resulted in a higher level of indebtedness among EU households. In this regard, between 1998 and 2007, the debt-to-disposable-income ratio of European households, an important indicator of the burden of the debt, has increased from 64.7% to 93.4%,[1] driving an overall expansion of the insolvency risks.

In the aftermath of the financial and economic crisis, the increasing concerns over the sustainability of such a level of debt turned out to be well founded. The rise in unemployment rates caused a sharp erosion of the financial conditions of many European households, negatively impacting on the capacity to meet their financial commitments. As a consequence, the level of household over-indebtedness has remarkably increased across all the EU member states, causing significant welfare losses for individuals and instability within the financial sector. In facing these challenges, this paper argues that, besides the necessary legislative provisions aiming at ensuring consumer protection, appropriate measures need to be taken in order to mitigate the risks and improve the prevention of over-indebtedness.

To be effective, these measures need to comply with a common methodology across the EU, which has to be based on a clear set of definitions and indicators. Analysing the nature and the impact of over-indebtedness will help us to understand the different dimensions related to over-indebtedness and contribute to the creation of a shared sense across EU countries of what over-indebtedness is, and how it should be treated both at national and European level.

This paper proceeds as follows. In section 1, after analysing the multilateral dimension of over-indebtedness, this paper explores the causes and the consequences of over-indebtedness. In section 2, it covers the legal dimension of over-indebtedness, highlighting the heterogeneity across the EU countries in terms of consumer protection and stressing the close relationship between over-indebtedness and personal insolvency procedures. In section 3, starting with the

[1] Data source: ECRI Statistical Package 2016.

recent developments in EU legislation, the analysis focuses on the treatment and the prevention of households' over-indebtedness, highlighting the role of financial education, debt-advice service and early detection schemes.

# 1. Over-indebtedness in the EU

- *The dimensions of over-indebtedness*

Over the period 1998-2007, the sum of total outstanding loans granted by monetary financial institutions (MFIs) to households has increased by almost 70% in real terms, driven by a remarkable expansion in the credit market in both the EU 15[2] countries and the so-called new member states (NMS).[3] This produced an overall growth in consumption and investment in the EU, which has had a positive impact on GDP growth and the employment rate. However, already in the years before the outbreak of the 2007 financial crisis, it was uncertain if the increasing level of household debt was set to be ''a movement towards a new equilibrium or, rather, a riskier financial position'' in the household sector (Rinaldi & Sanchis-Arellano, 2006). In this regard, the outbreak of the Great Recession revealed that the sharp increase in the level of indebtedness of households has been a major driver of financial fragility in the EU.

After 10 years of continuous expansion, the combination of the financial and sovereign crises caused an immediate standstill in the European credit market. Over the period 2008-14, the total lending to households in the EU has contracted by 3.7%, while an increasing level of unemployment generated an alarming expansion in the number of over-indebted households. As a result, between 2007 and 2013, the share of the population in the EU in arrears increased on average from 3.2% to 4.4%. In some countries, household credit turned out to be particularly vulnerable, as in Ireland, Greece and Cyprus where the share of population in arrears in 2013 was respectively 6.6%, 17% and 22% of the total population.[4] In the same vein, the levels of repossessions increased significantly across all member states, recording their peaks in Ireland, Spain and Greece.

Therefore, taking into account the lessons drawn from the crisis, scholars and policy-makers have recently focused on the impact of the household sector vis-à-vis of stability of the financial sector, analysing the nature, the causes and the consequences of households' over-indebtedness.

Although it does not have clear borders, household over-indebtedness can be defined as *the inability of a household to meet contractual financial obligations on time over a sustained period of time.* This uncertainty arises from the fact that the concept of over-indebtedness recognises more than one perspective. Therefore, it is useful to bear in mind that definitions and indicators may vary according to the purpose they serve.

On one side, indeed, as over-indebtedness might cause a sharp contraction in the living conditions of the households concerned, it requires the adoption of appropriate legislative provisions in order to guarantee an effective protection of consumers. Taking up this legal

[2] EU15 comprises the following member states: Austria, Belgium, Germany, Denmark, Greece, Spain, Finland, France, Ireland, Italy, Luxembourg, the Netherlands, Portugal, Sweden and the UK.

[3] NMSs are the 13 countries that joined the EU either as part of 2004 enlargement or subsequently. The group consists of Bulgaria, Croatia, Cyprus, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Malta, Poland, Romania, Slovenia and Slovakia.

[4] Data source: Eurostat EU-SILC survey

dimension, legislative provisions regulating the situation of over-indebtedness may be defined as an *ex-post* approach, since they aim at regulating a factual situation of inability to meet contractual obligations.

On the other side, as relatively high levels of indebtedness are correlated on average with higher risks of insolvency, over-indebtedness increases the risks of financial instability. In this regard, households' over-indebtedness also admits an *ex-ante* approach, based on the prevention against over-indebtedness and the *early detection of vulnerable households*. The development of this latter dimension is particularly important for European credit institutions as it would improve the resilience and the stability of the financial system in the EU.

In term of measurement, statistics on arrears and on debt settlements are widely recognised indicators of over-indebtedness in the EU. However, complementary indicators, such as specific financial ratios, might be applied to develop a common methodology for the prevention of over-indebtedness. Finally, over-indebtedness also implies a psychological element, which could be captured through subjective measures related to individual perceptions of the burden of the debt. The validity of these measurements, however, are based on the unrealistic assumptions that households are fully aware of the risks related to financial products, they are able to accurately predict all their life events and they take the necessary measures to preserve the sustainability of their financial commitments.

- *Causes and consequences of over-indebtedness*

Analysing the causes of the over-indebtedness will help in understanding the dynamics underlying the emerging situation of insolvency, and it constitutes the first step towards designing appropriate measures for both for the protection and the prevention of household over-indebtedness. The related literature confirms the mixed nature of household over-indebtedness and tends to distinguish between causes related to households' financial conditions and credit-institutions' behaviour (European Commission, 2008; Bank of France, 2014; Civic Consulting, 2013; D'Alessio & Iezzi, 2013; and Schicks, 2011).

Regarding households' financial conditions, according to a survey conducted by the Bank of France (2014), over-indebtedness is statistically related to specific situations. Unemployment or deteriorating employment conditions are at the basis of over-indebtedness for 23% of the cases. It is worth mentioning that in most cases, those changes are the result of exogenous shocks in the labour market. Permanent or non-temporary budget constraints represent the main driver of over-indebtedness for 17% of the households in the sample. Those situations are often characterised by an atypical work contract, poor budget management or weak financial education. Routine use of credit constitutes the most important cause of over-indebtedness for 14% of the sample. Finally, inter-generational assistance represents 5% of over-indebtedness cases, usually linked to vulnerable financial positions reached after providing financial help to a family member. Nevertheless, according to the survey, for 41% of over-indebted households, the inability to meet regular payments arises from the ''conjunction of significant life events''. As a consequence, for a substantial share of the sample, over-commitment is due to the combination of different circumstances, intrinsically characterised by different levels of predictability. Events such as separation, divorce, unemployment, illness or death of a member of the household may significantly contribute in causing a situation of over-indebtedness.

In Austria, the situation of over-indebtedness is caused in 43% of the cases by unemployment or a drop in household income, 18% by failed entrepreneurship, 12% by divorce or separation and 21% by regular budgetary problems (ASB Schuldenberatungen. 2012). Use of drugs, alcoholism and gambling may also trigger a situation of over-indebtedness (Valins, 2004).

Eurobarometer and Eurostat surveys confirm such a multi-dimensional nature of over-commitment. Moreover, data suggest that specific factors such as the number of dependent children or adults, the marital status and the employment situation are statistically correlated to the probability of over-indebtedness.

Turning to the role of credit institutions, irresponsible lending acts as a complementary driver of household over-indebtedness in the EU. The severity of the crisis was particularly high in those countries in which the credit markets experienced an exceptional expansion between 2003 and 2007. A bias towards over-confidence on the part of the banking sector vis-á-vis the global economic outlook might have stimulated excessive risk-taking strategies, contributing to an increase in the average level of indebtedness. In Spain, for example, identical loan-to-value (LTV) ratio and interest rates were applied on mortgages granted to both permanent and temporary workers (Akin et al., 2014). Besides, lax regulation on consumer protection left room for unclear or misleading advertisement of financial products. Accordingly, the combination of lax lending standards and inadequate regulatory provisions are likely to have exacerbated the level of indebtedness of EU households.

In the absence of adequate legislative framework, over-indebtedness may lead to severe consequences both for the individuals concerned and for the stability of the financial sector as a whole. Health issues correlated to high levels of stress, reduced labour market participation, social exclusion and poverty are among the risks of over-indebtedness (D'Alessio & Iezzi 2013). Moreover, depending on the lending criteria applied throughout the credit cycle and the intensity of the shock, over-indebtedness may produce a long-lasting welfare loss for the society. The explosion of a financial bubble and the consequent credit crunch determines the deflation of asset prices, producing a potential or actual situation of illiquidity of financial intermediaries (Fisher, 1933; Bernanke, 1983). Finally, the consequent rise of unemployment fosters self-reinforcing deflationary dynamics.

In conclusion, taking into consideration the multi-dimensional nature of the phenomenon, the impact of unforeseeable life events on households' financial conditions and the effects of irresponsible lending and excessive risk-taking by the banking system, national legislators should ensure that their legal frameworks effectively guarantee a fair allocation of credit risks between consumer and credit institutions, defining the necessary legal procedures to grant relief or the discharge of the debt, according to the particular circumstances.

## 2. Over-indebtedness from a legal perspective

In spite of the increasing concerns over the level of household indebtedness, little harmonisation has been reached at the European level in terms of approaches, definitions and indicators. The development of a common approach, indeed, is hindered by the existence of national resistance on the basis of different sets of preferences and legislative provisions. The presence of strong domestic bias and the impact of different legal traditions across the EU member states vis-à-vis over-indebtedness and personal insolvency are important factors explaining the lack of a broad consensus around this topic. By its own nature, indeed, the concept of over-indebtedness is inevitably conditional to a subjective judgement. Different national approaches may be applied, for instance, on the level of indebtedness to be considered as excessive or on the level of exemption of sizeable assets.

Despite all these limitations, the first step taken by the European Commission in response to the increasing concerns voiced about the level of indebtedness was to promote a study to find common ground for an ''operational definition'' of over-indebtedness. Accordingly, the Commission reviewed the existing legislation in order to identify common features that should constitute the core of a common definition. However, a first limitation was given by the fact that no official definition of over-indebtedness was available in many countries, including Lithuania, Bulgaria, Italy, Spain and Greece. Where recognised, over-indebtedness was often indirectly defined, and it tended to be assimilated to the situation of personal insolvency. For example, the Danish Bankruptcy Code of 1984 provides that ''the bankruptcy court may, at the debtor's request, issue a ruling on debt relief if the defendant proves that the debtor is not able to and within the next few years has no prospect to meet their debt obligations''. In Czech Republic, as characterised by the Insolvency Act of 2006, ''a debtor is considered insolvent if he/she has financial obligations that have not been met even upon the lapse of 30 days after maturity and if he/she is unable to settle these obligations''.

In France, the UK and a few other countries (such as Belgium, Austria and Luxembourg), an operative definition of over-indebtedness exists. In France, over-indebtedness is regulated by Art. L.330-1 of the Consumer Code (Code de la Consommation) and is defined as a ''manifest inability of the debtor, who is acting in good faith, to face up to the whole of his/her non-professional debts due or accrued''. In the UK, over-indebtedness is defined as the situation in which a ''household or an individual is in arrears, on a structural basis, or at a significant risk of getting into arrears on a structural basis'' (Oxera, 2004). In Germany, over-indebtedness was already previewed under the general bankruptcy law but national authorities have developed a specific definition. The Federal Ministry for Family Affairs, Senior Citizens, Women and Youth considers a household as over-indebted when its income ''in spite of a reduction of the living standards, is insufficient to discharge all payment obligations over a long period of time'' (Haas, 2006).

Therefore, after having taken in account the heterogeneity of the different formulations across the EU, the European Commission highlighted four distinct features related to over-indebtedness.

i. Concerning the scope, over-indebtedness has to be considered at the household level, as individuals usually pool together different sources of income.

ii. In its economic dimension, over-indebtedness defines a situation of incapacity to meet any type of financial commitments on time (mortgage, rent, utility bills …).

iii. A specific temporal dimension specifies that the above mentioned inability is characterised as a non-temporary situation, presenting, therefore, a structural basis.

iv. Finally, the situation of over-indebtedness and the related protection have to take in account the preservation of minimum standards of living.

However, despite the efforts made by the Commission to harmonise the different approaches and definitions, a recent survey of various stakeholders – encompassing the financial industry, civil society, public authorities and independent experts –reported the continued lack of a broad consensus. Indeed, 53% of the stakeholders declared that they did not use a general definition of over-indebtedness and 34% claimed that the common definition is directly related to the national legislation (Civic Consulting, 2013).

Nevertheless, since 2008, as a consequence of the financial and economic crises, increasing rates of indebtedness and insolvency have necessitated the development of new legal frameworks, especially in the countries in which no legal provisions allowed debt discharge or a *fresh start* for over-indebted households. This was particularly the case for Ireland, Greece, Italy and Spain, amongst others.

Until 2012, the Irish legislation governing personal insolvency did not provided any automatic debt discharge for over-indebted individuals. At the issuance of a bankruptcy order by the High Court, all of a debtor's assets, including his family home, were seized and liquidated to meet creditors' obligations. The discharge of the debt was conditional on a period of 12 years of good conduct or to the full repayments of creditors (Gerhardt, 2009). According to the modifications introduced by the Personal Insolvency Bill of 2012, ''the debtor must be insolvent/unable to pay their debts'' to benefit from the protection granted by the law. In case of over-indebtedness, therefore, the discharge of the debt is automatically granted three years after the judicial bankruptcy.

Before the crisis, in Italy and in Greece, no personal insolvency procedures were foreseen by the law, as consumers were not entitled to objective and subjective conditions required by the law to initiate bankruptcy procedures. In fact, insolvency procedures were strictly reserved for corporations or commercial activities in general. Nevertheless, the sharp expansion of the share of citizens at risk of social exclusion and poverty led national legislators to develop the necessary legislative measures to ensure effective consumer protection. In Greece, Art. 1 of Law 3869/2010 on ''Debt adjustments of over-indebted individuals'' provides that ''protection is granted to individuals who are excluded from resorting to commercial bankruptcy law, who - without intention - are in permanent inability to serve their debt''. Similarly, in Italy, as provided by Law 3/2012, over-indebtedness is defined as ''a situation of persistent imbalance between obligations and assets that can be promptly liquidated to meet them, and the definitive inability of the obligor to meet regularly its obligations''. The approval of the new Italian and Greek laws represents a remarkable structural improvement of consumer protection, as in both cases the law provides the possibility of the discharge of the debt at the end of the repayment plan.

In Spain, personal insolvency provisions were introduced within the Spanish Bankruptcy Law (Law 22/2003), which did not admit the discharge of the debt for individuals (Gerhardt, 2009). The issue of over-indebtedness was tackled for the first time in a study requested by the Spanish Consumer Protection Authority, in which it was defined as ''a situation of financial hardship caused by excessive debt assumption in relation to income and disposable assets [...] that is, to be in a situation of such a degree of acceptance of payment commitments that injures or threatens the ability of adequately and orderly pursing the obligations required of a person or entity'' (Gutiérrez de Cabiedes, 2009). The adoption of the Royal Decree 1/2015 has finally introduced in the Bankruptcy law Art. 178 bis, which grants consumers the possibility of a discharge of debt after fulfilling the repayment plan and the liquidations of the sizeable assets of the debtor.

In conclusion, the revision of different national legislation allows a categorisation of the countries studied into two main groups. In Denmark, Czech Republic, Ireland, Spain and the UK, the legislative provisions related to over-indebtedness are embedded within the general bankruptcy law. Conversely, in Italy, Greece and France, where insolvency procedures are strictly reserved for corporations, national legislators have introduced specific legislative provisions on household over-indebtedness. However, despite the heterogeneity of the different formulations, a ''lowest common denominator'' exists vis-à-vis the situation of over-indebtedness. In both groups, over-indebtedness tends to be directly or indirectly defined in strict correlation to the situation of personal insolvency. This element reflects the preference of national legislators to develop one specific dimension of over-indebtedness, namely *ex-post* protection of consumers.

In most EU countries, the recognition of a structural imbalance between disposable income and financial commitments allows the consumer/household to agree with the creditors on a repayment plan, subject to the good faith of the consumer. The fulfilment of the repayment plan allows the consumer to obtain the discharge/relief of the debt. It is worth mentioning that meaningful differences across the countries concern the level of exemption granted to insolvent individuals, the conditions for debt discharge as well as the different thresholds applied for the approval of the final restructuring plan of over-indebted individuals.

Nevertheless, the situation of over-indebtedness should not be understood as synonymous with the situation of personal insolvency, as the former occurs on a temporary basis before the situation of actual insolvency materialises (Gutiérrez de Cabiedes, 2009). Beyond the common features shared by the different pieces of legislation, the definitions of over-indebtedness adopted in Spain and the UK have the advantage of capturing the complexity of the concept. The introduction of the elements of ''risk'' and the ''threat'' of becoming insolvent encompasses the dimensions of both consumer protection and prevention against households' financial distress, including thereby both real and potential situations of insolvency. This integration opens the door to a complementary application based on an *ex-ante* approach, which may act as the basis for the implementation of a micro-prudential regulation.

# 3. Treatment and prevention of household over-indebtedness

Considering the multilateral causes and the wide spectrum of consequences of over-indebtedness, its prevention and treatment should actively involve both borrowers and lenders. In this regard, this section analyses the recent developments in EU legislation that aims at setting standards of transparency and harmonising the legal provisions governing consumer and housing loans. Thereafter, the analysis highlights the positive impact of financial education and debt-advice services in the reduction of the risks of over-indebtedness. In the last section, we turn our attention to the introduction of preventive measures, explaining the rationale and methodological foundations for the adoption of a common scheme of *early detection of vulnerable households.*

- *The legal framework at the EU level*

The Consumer Credit Directive (CCD), the Mortgage Credit Directive (MCD) and the Unfair Commercial Practices Directive (UCPD) constitute the relevant body of legislation at the EU level. They aim to define a clear legal framework for the European credit institutions, decreasing the barriers for cross-border lending and improving the prevention of over-indebtedness within the EU. With particular reference to CCD and MCD, they both introduce important new elements. They contain specific provisions on pre-contractual and contractual standardised information that has to be presented to the client as well as particular provisions on the advertisement of financial products. Accordingly, credit institutions are obliged to provide the consumer with a European Standardised Information Sheet (ESIS) in the case of housing loans, and with the Standard European Consumer Credit Information (SECCI) in the case of consumer loans. Consumers have a right to a sufficient amount of time (discretionary to national legislation) to study the impact of the loans conditions on their financial situation. In addition, Arts 8 and 18 respectively of CCD and MCD establish the obligation for all EU credit institutions to pursue an accurate evaluation of the creditworthiness of each client, taking into account the affordability of their financial commitments in the long-term. Art. 19 of the MCD requests member states to take the necessary measures to ensure reliable and independent valuation of residential property, harmonising their standards to the recognised international levels. Furthermore, both Directives provide consumers with a tool for the calculation of the Annual Percentage Rate of Charge (APRC), which has the advantage of giving consumers a reliable benchmark against which to compare lending offers from different credit institutions. Member states are required to ensure that early repayment, although with certain conditions attached, is a right granted to the borrower. Finally, Art. 23 of the MCD grants, under the conditions previewed by the legislation of the member states, consumers who had contracted a mortgage denominated in a foreign currency the right to convert the sum unilaterally into their home currency. Finally, Art. 28 requires member states to adopt the necessary legislative measures to encourage credit institutions to find an agreement with the debtor before the parties enter in a foreclosure procedure.

All the measures introduced aim at increasing transparency and improving consumer protection, but it is worth noting that the word over-indebtedness is mentioned only once in the introductory paragraphs of the CCD, and few references are dedicated to the need to harmonise national practices. At the present time, a common space of discussion at the EU level could contribute to the creation of a common understanding of over-indebtedness and foster the sharing of best practices. Financial education, income adequacy, responsible lending, early engagement of creditors, prevention of financial exclusion, collective debt settlement, temporary suspension of debt servicing and debt-advice services are just a small selection of the best practices aimed at curbing over-indebtedness (Civic Consulting, 2013).

- *Financial education*

Regarding EU households, the situation of over-indebtedness is triggered in most of the cases by unforeseeable life events, poor budget management or the interaction of both elements. The ability to cope with financial hardship is, therefore, related to the level of precautionary savings, which results from the combination of objective and subjective components (Bouyon, 2015). Therefore, in its subjective component, precautionary savings, and indirectly the ability to prevent over-indebtedness, is linked to the level of financial education of EU households. This can be defined as the process by which individuals ''develop the skills and confidence to become more aware of financial risks and opportunities, to make informed choices, to know where to go for help, and to take other effective actions to improve their financial well-being'' (Atkinson & Messy, 2012). In 2007, the European Commission adopted a Communication on financial education, mentioning already the importance of designing new learning strategies for both children and adults. Measuring and promoting financial literacy are, therefore, core elements in order to strengthen consumers' ability to avoid and cope with over-indebtedness. The pilot study recently launched by the OECD in 14 different countries confirms that the majority of the sample has only a basic understanding of the financial sector and highlights some evidence of over-confidence (Atkinson& Messy, 2012). Citizens of the EU countries included in the survey have shown on average a better understanding, although the level of knowledge remains limited. Therefore, at present, further efforts should be taken both at the EU and national level to promote and integrate financial literacy in the schooling system.

- *Debt-advice services*

Furthermore, adequate provisions need to be taken at the EU level in order to harmonise and improve the accessibility and the efficiency of debt-advice services. The support provided to consumers by debt-advice agencies plays a prominent role in terms of protection from the risks related to over-indebtedness. According to a recent study, however, systems across the EU member states diverge substantially in terms of funding, efficiency and accessibility (Dubois, 2016). Indeed, public debt advice is provided in Estonia, Finland, Hungary, the Netherlands, Sweden, Austria, Ireland and Luxembourg. Particularly interesting is the practice shared by Ireland and Luxembourg, where national authorities and their local branches are competent for providing consumers with debt advice. In Ireland, the Money Advice and Budgetary Service (MABS) offers different types of services for households, helping consumers to deal with high levels of indebtedness, factual or potential over-indebtedness, personal insolvency and bankruptcy procedures. Conversely, in the rest of the EU, debt advice is provided by private agencies including consumer associations, professional debt-advice bureaus and NGOs. For instance, in Greece, Slovakia, Spain, Poland and Portugal, debt advice is offered either by consumer associations or private bureaus. Nevertheless, in many cases, budgetary constraints for consumer associations, and high costs for private bureaus reduce significantly the accessibility to the service and limit its positive impact. In France, the UK, Germany and Czech Republic, where debt advice is provided by NGOs, the service is subjected to some explicit restrictions. Finally, in Slovenia, Croatia, Romania, Bulgaria, Cyprus, Lithuania, Latvia, Denmark, Malta and Italy, debt advice is given limited visibility, to the detriment of the quality and the accessibility of the service. Designing a model for debt advice at the EU level, aiming at providing consumers with an independent, professional and full accessible service might be a crucial step in alleviating the impact of over-indebtedness and helping to find efficient solutions according to the different cases.

- *Towards a common methodology for the early detection of vulnerable households*

Unfortunately, in most cases, debt-advice represents a measure of treatment of over-indebtedness rather than an efficient mechanism of prevention. Attention should now also be directed towards the development of a common methodological approach for an effective prevention of household over-indebtedness. The adoption of a common scheme of *early detection of vulnerable households* would positively impact the European financial system. The capacity to detect financial hardship would decrease the risks of insolvency, thereby strengthening the stability and the resilience of the European credit market. For this purpose, both the identification and the calibration of appropriate financial indicators are crucial elements. Common indicators proposed in the literature are the loan-to-value (LTV) ratio, the debt-to-income (DTI) ratio and the debt service-to-income ratio (DSTI).[5]

Regarding the LTV ratio, this cannot be considered as an appropriate measure for preventive detection as it does not really measure the sustainability of payments for households. Young professionals, for instance, in spite of relevant income, may not be able to afford the required down payment to meet the LTV limits and therefore would be excluded from the credit market. More sophisticated approaches are the debt-to-income and debt service-to-income ratios. Both of these indicators would be potential indicators but a quantitative analysis and an accurate calibration are required as they are inevitably subject to statistical errors, related to misidentification of over-indebted households.

A recent paper **(**Banbula et al., 2015**)** proposed a model for the calibration of both limits, investigated the nature of these errors and provided, in our view, an accurate analysis of the effectiveness of those indicators. According to this study, carried out on a unique dataset on Polish households, no reasonable limits for the DTI ratio are sufficiently accurate to limit statistical error. Conversely, they found that a limit of 40% DSTI ratio is able to detect some 47.5% of truly indebted households with a 'false positive rate' of only 5.5%. With a 20% DSTI limit, the capacity to capture truly over-indebted households increases up to 75.8%, even if, with such a low limit, the 'false positive rate' increases to 29.4%.

If validated by other empirical studies, these results suggest that a quantitative approach towards over-indebtedness is feasible and its application in over-indebtedness prevention is

[5] Debt service to income is the ratio between monthly debt payments and income. The lower the value of this ratio, the higher is the affordability of the debt. Conversely, high values of this ratio are on average correlated with higher risks of default.

justified. Indeed, although very low limits of DSTI might be very costly in term of statistical accuracy, the results of these tests might always be corrected by human intervention. Therefore, continuous monitoring of the DSTI ratio on micro data may be effective in the early detection of vulnerable households and therefore an effective prevention of over-indebtedness. Leading from these considerations, many different frameworks may be proposed to improve the effectiveness of such a preventive control. Debt-advice services, Consumer Credit Registry Bureaus or credit institutions could be tasked with conducting regular evaluations of the sustainability of the debts of their clients over time. Eventually, in the case of high risks of over-indebtedness, a wide range of solutions might be proposed and applied according to the different circumstances of the debtor. In this vein, the decree enacted by the French government, allowing the implementation of the Charter on Banking Inclusion and Over-indebtedness Prevention,[6] requires that ''credit institutions design one or multiple mechanisms of early detection of their clients in situations of financial fragility, combined with an internal warning system. […] In compliance with the Computer and Freedom act,[7] they must develop a specific device allowing the detection of situations of financial hardship faced by their clients towards the contracted financial products […] taking into consideration the profiles of their clients and their financial behaviour''.

Before such an ambitious project of *micro-prudential regulation* can be launched, however, it will be necessary to harmonise the collection of data on debt services, which in turn requires the design of balanced legislative measures regarding data treatment, in order to make this confidential information available for consultation by the competent authorities. Nevertheless, given the heterogeneity across the different credit market in the EU, further studies are first required in order to test the effectiveness and the consistency of statistical indicators in the early detection of vulnerable households.

## 4. Conclusions

Growing concerns over the high level of indebtedness across the EU have captured the attention of scholars and policy-makers on the risks related to over-indebtedness. This study showed that households' over-indebtedness is a complex phenomenon, since it admits different perspectives and application fields, catalyses the interests of different economic agents and is subject to different national approaches. For these reasons, in order to achieve a better understanding of households' over-indebtedness, this study distinguishes the legal from the economic dimensions, which are respectively related to consumer protection and financial stability.

With regard to the legal dimension, the efforts made by the European Commission in defining a common ''operational definition'' faced many difficulties, due to the lack of legislative provisions related to over-indebtedness in most of the EU member states. Nevertheless, the outbreak of the financial crisis has compelled national legislators to implement new legislative frameworks for over-indebted households. Between 2010 and 2012, indeed, new provisions concerning the debt discharge for over-indebted individuals were introduced in Ireland, Greece, Italy and Spain, triggering a remarkable convergence towards the level of consumer protection found in the UK, France and Germany.

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[6] Arête du 5 novembre 2014 portant homologation de la charte d'inclusion bancaire et de prevention du surendettement

[7] ''Informatique et liberté''.

Regarding the formal legitimacy, our analysis of the legislation of these countries identifies the existence of two different models. In the first model, provisions related to over-indebtedness are embedded in general bankruptcy laws, as in Denmark, Czech Republic, Ireland, Spain and the UK. Conversely, France, Italy and Greece belong to the second model, which is characterised by the introduction of specific legislative procedures on over-indebtedness.

We found that in all the legislation analysed, the situation of over-indebtedness tends to be defined in strict correlation to the situation of personal insolvency. However, personal insolvency and over-indebtedness define two different situations. In fact, the former describes the actual inability to honour one's financial commitments, while the latter defines a structural situation of financial hardship resulting from an excessive amount of debt. Therefore, besides the *ex-post* intervention, over-indebtedness admits also an *ex-ante* approach, based on the mitigation of the risks and the prevention of the situation of over-indebtedness.

In this regard, we argue that the new legal framework recently adopted at the EU level has introduced important measures strengthening the level of client protection, but it has produced only a limited impact when it comes to the effective harmonisation of national practices in the EU. Besides, evidence clearly confirms that financial education plays a crucial role in the prevention of over-indebtedness, but further efforts need to be taken in designing adequate learning strategies for children and adults. This study also highlighted the need to improve the quality, accessibility and efficiency of independent debt-advice services, as they may meaningfully contribute to alleviating the impact of over-indebtedness both at the individual and the aggregate level.

Nevertheless, we argue that a major contribution to the adoption of a common methodology vis-à-vis households' over-indebtedness, would come from the development of a common scheme for the *early detection of vulnerable households*, based on a set of accurate statistical indicators. Basing our analysis on recent quantitative research, this study underlines the potential of applying debt service-to-income limits as a valuable tool towards innovative micro-prudential regulation. The viability of this approach, however, is conditional on the validation of the consistency and effectiveness of the indicators proposed across EU countries. Accordingly, further research on the optimal calibration of DSTI limits is necessary in order to define a common methodology for the early detection of over-indebtedness, regardless of the heterogeneous situations found across the EU.

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