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CENTRE FOR EUROPEAN POLICY STUDIES

Consumer Bankruptcy Regimes in the US and Europe

Further effects and implications of the crisis

CEPS Working Document No. 318/July 2009

Maria Gerhardt

Abstract

Consumer insolvency is a topic that has gained much prominence in the context of the financial crisis on both sides of the Atlantic. In countries such as the US and the UK, the number of bankruptcy filings has been soaring in recent years, and is not expected to go down in the near future. In Ireland and Spain, however – two other countries that have been hit hard by the crisis – consumer bankruptcy cases remain very low, and this phenomenon is linked to the severe insolvency regulation in place in these countries.

This CEPS Working Document explains the consumer bankruptcy procedures in the US and five European countries with quite different approaches: the UK, Ireland, Germany, France and Spain. Since there is no law on consumer insolvency in Italy, the situation in this country is outlined only briefly. When considering current statistics on consumer bankruptcies so far, the first effects of the economic crisis can be observed, so the question arises as to what is yet to come and which bankruptcy procedures are the most appropriate. After a short presentation of each insolvency procedure, the developments in national bankruptcy numbers are traced, highlighting striking developments in the different countries studied here.

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1. Introduction

The latest US statistics on consumer bankruptcy filings[1] show that numbers are soaring. Filings surpassed 1 million in 2008, which represents an increase of 31% compared to 2007. This number is expected to reach 1.4 million or more in 2009.[2] Higher insolvency and default rates lie at the heart of the subprime crisis: consumers' failure to make payments on their housing loans caused major value losses in mortgage-backed securities (MBS), since they derive their worth from regular loan payments and property values. As a result, financial institutions and companies that had invested heavily in MBS saw their profits, and eventually their capital, decline. This development led to tightened credit not only in the US, but around the world, and was one of the triggers of the global credit crisis.

The rising trend of non-repayment has spread from housing loans to other types of credit, with credit cards being affected to a greater extent than other consumer credit segments. Within the past three years, US banks have reported significant increases of quarterly charge-off rates for residential real estate loans from 0.09% (1st quarter 2006) to 1.80% (1st quarter 2009) and for credit cards from 3.10% (1st quarter 2006) to 7.49% (1st quarter 2009).[3] At the same time, the numbers of consumer bankruptcies in the US have increased steadily. The trend of consumers' credit default and filing for bankruptcy can be observed not only in the US, but in European countries as well. While the volume of delinquent loans to households in Spain increased moderately at the beginning of the years 2000, it augmented from €4.1 billion (2005) to €24.3 billion (2008)[4] and Spanish consumer insolvency filings increased during the same period as well.

In the past, little attention was given to the various consumer insolvency regimes that exist in different countries to resolve financial difficulties. When comparing the US with a number of European countries, we note huge differences in legislation. In the US, the approach is rather supportive to consumers in terms of less stringent and less tedious bankruptcy procedures – under certain circumstances individuals can be free of debt within a few months. On this side of the Atlantic, insolvency regulations tend to give priority to creditors' rights, allowing for the recuperation of a greater share of claims, often through stricter rules and longer periods of good conduct for consumers. Ireland is an example of such legislation that foresees a waiting period of 12 years before the discharge of consumer debt.

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[1] The terms 'insolvency' and 'bankruptcy' are used interchangeably in this Working Document.

[2] As stated by Samuel J. Gerdano, Executive Director of the American Bankruptcy Institute (http://www.abiworld.org).

[3] Official numbers can be found at the US Federal Reserve (http://www.federalreserve.gov).

[4] The Banco de Espana classifies loans as "doubtful" once they are more than three months overdue. Statistics on doubtful loans and bank losses can be found at http://www.bde.es.

Both approaches have advantages and disadvantages. While creditors tend to have greater legal means for the recuperation of outstanding loans in European countries, they may be forced to write off huge amounts in the US when debtors are being granted debt discharges. At the same time consumers might prefer the US legislation, permitting them to rid themselves of debt quickly and encouraging new spending. Insolvency laws are crucial in the context of the ongoing crisis since they determine how consumer debt may be cancelled, representing further losses to creditors. The possible influence, effects and consequences of different bankruptcy procedures is an important question.

2. The US: Fast track to debt discharge

In the US, bankruptcy legislation is clearly consumer-oriented. Once admitted to bankruptcy proceedings, consumers are protected in several ways, for instance by high exemption rules that allow them to keep a great share or all of their property. In a few US states, such as California and Arizona, consumers may also be shielded from the consequences of unpaid housing loans, as their loans are of a "no recourse" nature[5] under certain conditions laid down by the respective real estate regulation. This type of loan gives homeowners the possibility to exit mortgages by simply leaving the collateral to the creditor, without personally being held liable for a possible loss in value. No recourse loans generally favour borrowers, because they can walk out on their loan and penalise mortgage providers if left with depreciated collateral. In most states, creditors can file for a deficiency judgement in case foreclosure did not produce enough funds to repay a mortgage.[6] However, if a debtor has lost his house to foreclosure the outlook of collecting a deficiency statement is not very optimistic.

Consumer and business insolvency is regulated by federal law under the US Bankruptcy Code. The principal purposes of the bankruptcy law are, firstly, to give an honest debtor a 'fresh start' in life by relieving him of most of the debts and secondly, to repay creditors in an orderly manner to the extent that the debtor has assets available for payment. The order of the two purposes clearly reflects the strong focus on debtors' interests. Individuals can apply for bankruptcy under Chapter 7, 11 and 13 of the Bankruptcy Code, though Chapter 11 is mostly applied to businesses. The majority of consumer bankruptcies are processed under Chapter 7: in 2008, 67% of all non-business bankruptcies were filed under Chapter 7 and the other 33% under Chapter 13.

Under Chapter 7, any individual may apply for insolvency, irrespective of the amount. The procedure foresees that the debtor turns over all the non-exempt part of his property to a trustee for liquidation purposes, and the proceeds are then distributed to the creditors.[7] However, since there is often little or no non-exempt property in Chapter 7 cases, liquidation may actually not take place, which is why they are frequently referred to as "no-asset cases". Following the liquidation of non-exempt assets, the remaining debt may be relieved immediately.[8]

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[5] The 'no recourse' specificity is not part of federal bankruptcy legislation, but related to the loan contract.

[6] Deficiency judgements are allowed in 44 out of the 50 states, according to A. Crews Cutts, and R.K. Green (2004), *Innovative servicing technology: Smart enough to keep people in their houses?*, Working Paper BABC 04-19, Joint Center for Housing Studies, Harvard University, February.

[7] As mentioned above, the non-exempt part of property depends on state law, which varies widely but may include equity in a home or car, tools of the trade or some personal effects.

[8] Certain debts are not dischargeable under Chapter 7, for instance debts for alimony and child support, certain taxes or debts for certain criminal restitution orders.

Even though insolvency regulation is covered by US federal law, exemption law is regulated at both the federal and state level. In principle, state regulation applies, but many states allow debtors to choose between state and federal exemption law. Depending on the state, debtors may therefore save different amounts of their assets; for personal property[9] many states provide for exemptions of $15,000-$50,000 and the federal regulation for a total of around $45,000. All states also allow for homestead exemption, permitting debtors to keep a share or all of their principal residence. Federal regulation specifies a homestead exemption of $136,875, in most states that amount is below $100,000, but it varies widely across states. The regulations of homestead exemptions have become more generous in past years, and even Delaware, which did not allow for any home equity to be saved before, passed a bill in 2005 fixing a threshold for homestead exemption at $50,000. In several states, for instance Florida or Texas, state regulation does not even set any monetary limitation to homestead exemption; so if the debtor is permitted to Chapter 7, he may receive a debt discharge and still be able to keep his home.

The varying exemptions provisions imply that creditors may be able to recuperate different amounts of their outstanding loan, depending on the state in which the debtor resides. The cost of providing credit consequently differs across states, since lenders may be forced to write-off higher amounts in some states. This could lead to the conjecture that lenders may set interest rates according to their cost and possibility to enforce claims; variation of interest rates for mortgages and consumer loans is surprisingly small, however, with a variance of around 0.5%.

When considering the number of consumer bankruptcy cases, the level of homestead and property exemptions can become significant, since loose exemption laws are positively related to filing for bankruptcy, as has been argued by Gropp et al.[10] It is more probable that consumers file for bankruptcy and ask for a debt cancellation if they can keep much of their assets; this implies that under higher exemption provisions people are more likely to behave opportunistically. Gropp et al. state that bankruptcy exemptions can therefore actually be interpreted as partial wealth insurance. Taking this interpretation a step further leads us to the concept of moral hazard. In the context of insolvency and exemption provisions, moral hazard implies that debtors behave differently with generous exemption laws in place because they are running less risk of losing their assets. Debtors may be engaging in loan contracts less cautiously because they do not have to worry about losing their property in case of insolvency.

The whole procedure of Chapter 7 cases generally lasts 4 months, and according to the US Courts, more than 99% of individual debtors admitted to the chapter receive a discharge. Under Chapter 7, consumers have the advantage that debts are discharged without any future obligation; they do not have to comply with any rules or periods of good conduct. This implies that in those cases where bankrupts do not own any non-exempt property, they may enjoy a fast track to discharge, with only a slight penalty for default being incurred. This contrasts sharply with European countries, as discussed below.

Under Chapter 13, a debtor may save a greater share of his property, but it does not include immediate debt relief, rather a ‘reorganization’ of debt in order to reach a settlement plan. Under this plan, the debtor repays part or all of his debt over 3 to 5 years – depending on the individual's monthly income – and the remaining debt may be discharged upon completion of the settlement. For creditors, Chapter 13 is preferable, because of the higher chance of obtaining a larger part of the outstanding loan.

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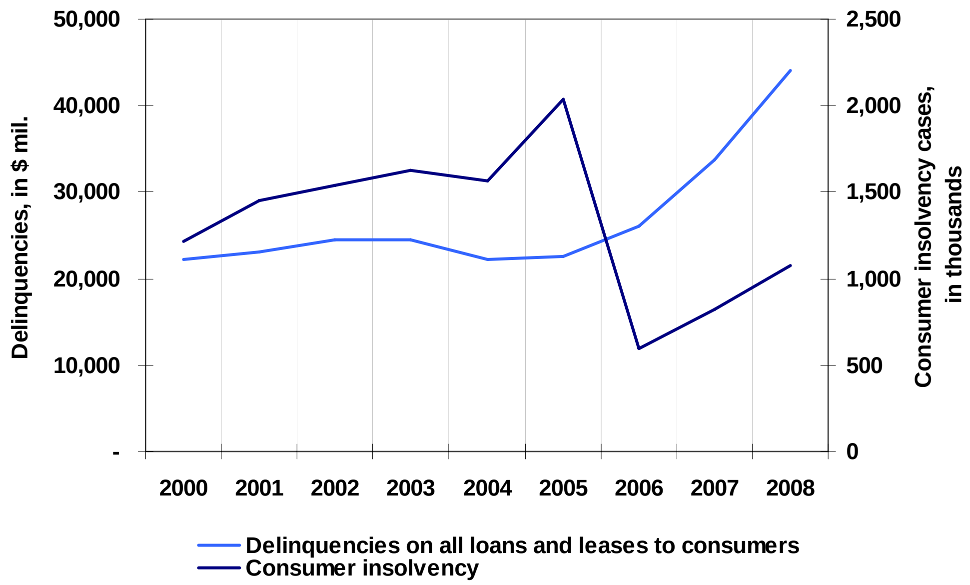
[9] Personal property mostly includes items such as cars, household furnishings, clothes or jewellery.

[10] R. Gropp, J. Scholz & M. White (1997), “Personal bankruptcy and credit supply and demand”, *Quarterly Journal of Economics* 112 (1), pp. 217-251.

The decision to file under Chapter 7 or 13 partly depends on the debtor's monthly income; individuals with a higher income need to apply for Chapter 13. For debtors, the advantages of Chapter 13 over 7 are that (1) the debtor gets to keep a greater part of his property and (2) some of the debt that cannot be discharged under Chapter 7 may be discharged under 13, such as debts for malicious injury to property or debts arising from property settlements in separation proceedings. For both chapters, the frequency of discharge is not strongly limited: a Chapter 7 discharge is possible every 6-8 years, depending on the previous relief, and a Chapter 13 relief only if it has not been granted in the previous 2-4 years.

Insolvency procedures in the US were modified in 2005 by the *Bankruptcy Abuse Prevention and Consumer Protection Act* (BAPCPA). The BAPCPA imposed stricter rules for bankruptcy applications, for instance with a restricted eligibility for Chapter 7 to limit the possibility of a fast debt discharge for individuals that are not completely destitute. The numbers of insolvency filings increased significantly in 2005 and decreased the following year, a development that was the result of the entry into force of the BAPCPA in 2005, as has been argued by White[11] and can be seen in Figure 1. Debtors were quick to file under the old regime before eligibility requirements were tightened.

Figure 1. Delinquencies and number of consumer insolvency cases in the US[12]



Source: US Courts, Federal Reserve.

[11] M. White (2008), *Bankruptcy: past puzzles, recent reforms, and the mortgage crisis*, National Bureau of Economic Research Working Paper No. 14549.

[12] Delinquency statistics include delinquencies on all loans and leases to consumers of all commercial banks at the end of the respective year. The Federal Reserve classifies loans as "delinquent" once they are overdue by 30 days or more.

The number of insolvency cases refers to the non-business bankruptcy cases commenced during the twelve month period ended on December 31st of the respective year.

2.1 Delinquency and charge-off rates

Even though the possibility to file for bankruptcy has been limited by the BAPCPA, numbers of bankruptcy filings have been soaring again since 2006 (see Figure 1) and crossed the mark of one million cases in 2008. Moreover, this number is not likely to decrease, since delinquency rates have been increasing across all sectors, as has been reported by the Federal Reserve. Within the past two years, the volume of delinquent consumer loans, excluding mortgages, at commercial banks has almost doubled from \$23.8 billion (1st quarter 2007, approx. €18.2 billion) to \$44.1 billion (1st quarter 2009, approx. €33.8 billion) and keeps on rising.

Credit card loans represent half the volume of delinquent consumer loans and the rate of non-paid credit card bills has been increasing in past years. The official US statistics published by the Fed on the average delinquency rate on credit card loans of all commercial banks has increased from 3.96% (1st quarter 2007) to 6.61% (1st quarter 2009). The rising number of delinquencies is reflected in high charge-off rates for credit card issuers. In April 2009, American Express and Citigroup's charge-off rates for credit cards stood at 10.1% and 10.2%, respectively. According to Reuters, analysts estimate that those rates could translate into potential losses of \$70-75 billion for credit card issuers.

With an outlook like this, the credit card sector is under severe strain and there is a danger of a credit card crisis – having at its source the same cause as the subprime bust: consumers failing to service their bills. Even without a major crisis in the credit card market, the fast-track debt relief of Chapter 7 may actually turn consumers' discharges into creditors' charges, transforming the rapid benefit of one party into the rapid loss for another.

2.2 Unemployment and insolvency

A factor that is of great significance for insolvency is unemployment, as it has been identified as one of the most important reasons that causes people to file for insolvency. This has been confirmed by several studies, among which a survey conducted amongst participants of credit counselling courses of the Institute for Financial Literacy.[13] In this study, job loss was cited as one of the four most prominent reasons for financial distress in the US. Further, according to Elizabeth Warren, Professor at Harvard Law School, job loss, illness, and family breakups are stated as the reasons for nearly 90% of bankruptcies.[14] In Fay et al. the probability of filing for bankruptcy increases with lower employment income,[15] so job loss contributes to more insolvency filings.

In the past years, unemployment and insolvency have been showing similar trends, as can be seen in Figure 2, below. The BAPCPA caused a massive break in insolvency data for 2005/06; the graph therefore strongly deviates for those two years, whereas the unemployment rate has evidently not been affected by the change in bankruptcy legislation (see Figure 2). The most recent numbers for US unemployment reached an alarming 9.4% in May 2009.[16] With job loss being one of the major reasons for filing for insolvency, and unemployment being a lagging indicator, the number of bankruptcy cases that are yet to come are expected to increase. Since Chapter 7 enables a fast discharge for individuals, the combination of rising unemployment

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[13] Institute for Financial Literacy (2007), *2007 Annual Consumer Bankruptcy Demographics Report*.

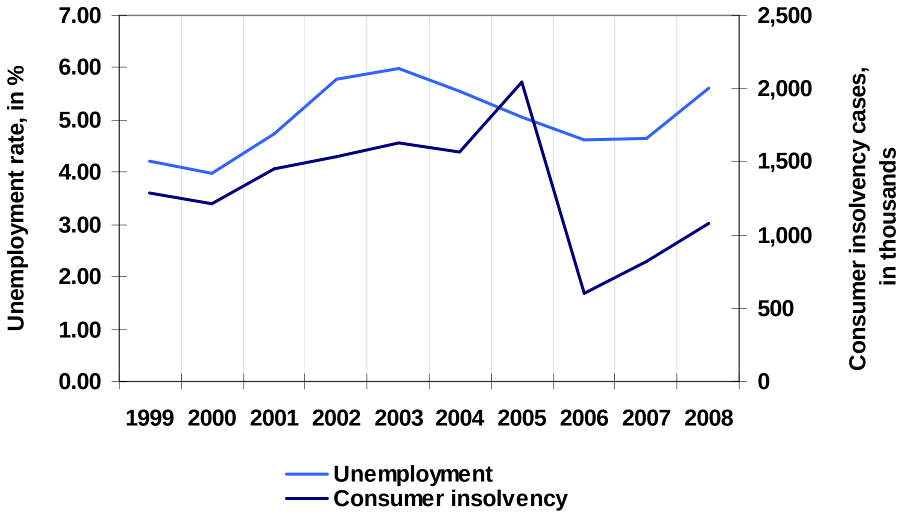
[14] E. Warren and A. Warren Tyagi (2005), "What's Hurting the Middle Class – The myth of overspending obscures the real problem", *Boston Review* (http://bostonreview.net/BR30.5/warrentyagi.html).

[15] S. Fay, E. Hurst & M. White (2002), "The Household Bankruptcy Decision", *American Economic Review* 92 (3), pp. 706-718.

[16] For comparison purposes, May's figures for US unemployment for 2007 and 2008 were at 4.5% and 5.5%, respectively.

together with financial distress will again heighten the volume of write-offs and losses that creditors have to bear in the near future.

Figure 2. US unemployment rate and number of consumer insolvency cases



Source: US Courts, IMF.

3. The UK: Shortened period of good conduct and decrease in stigma

Research on consumer bankruptcy in Europe has not been as extensive as in the US, nevertheless some similar trends can be observed. Of the European countries, the UK's bankruptcy legislation is the one that comes closest to the US approach on consumer insolvency, but is still stricter than the American provisions.

The Insolvency Act and Insolvency Rules, both of 1986, regulate personal and corporate bankruptcy in the UK. Various sections of the act have been modified by Part 10 of the Enterprise Act 2002,[17] most importantly the length of the period of good conduct before debt discharge, which has been shortened from 3 years to 12 months in order to ease consumers' financial distress.[18]

In England and Wales, any debtor or creditor can file for bankruptcy given that the debtor fails to make his payments. Once the court decides to issue a bankruptcy order against the debtor, his assets are all transferred to a trustee. The property that may be exempted is limited to those possessions that the debtor needs in his employment or home; all other assets of value, including the home itself, have to be turned in for liquidation.[19] It needs to be stressed that the UK borrower certainly does not benefit from the same debtor protection as in the US, because he is most likely to lose any house equity and realisable asset of value.

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[17] The individual insolvency provisions of the Enterprise Act 2002 came into force on 1 April 2004.

[18] This section outlines the proceedings in England and Wales; Scotland and Northern Ireland have separate insolvency services and divisions.

[19] Several alternatives to bankruptcy are possible in case the debtor wishes to save his property, for instance an informal arrangement with creditors or an Individual Voluntary Arrangement (IVA) with the creditors, which is a formal arrangement supervised by an insolvency practitioner.

After one year, the debtor is automatically (!) discharged from his debt, with a few exceptions that are not dischargeable, such as court fines or student loans. It is remarkable that no further decision of a judge is necessary once the 12 months have elapsed. The debt relief may even be issued earlier if an officer of the court files a notice in court upon conclusion of his enquiries.

The numbers of consumer bankruptcy cases in England and Wales rose strongly after 2004, when the period of good conduct was effectively reduced from 3 years to 12 months: the number of insolvency cases tripled from 35,604 in 2003 to 106,544 in 2008. Besides the shorter period of good conduct, the rising bankruptcy numbers are also paired with increasing levels of household indebtedness and a decrease in the stigma associated with insolvency.[20] As has been revealed in a study by the UK Insolvency Service, bankruptcy stigma is becoming less significant.[21] The results of two surveys conducted in 2004 and 2006/2007 show that there has been a decrease in the stigma perception amongst individuals, which implies that bankruptcy is becoming more socially acceptable.

The recent reduction of the period of good conduct from 3 years to 12 months clearly shows the intention in the UK to render the legal avenue of insolvency to resolve difficulties between debtors and creditors more accessible. The rising number of insolvency filings and decreasing level stigmatisation are therefore not surprising. Since the volume of household borrowing has not been increasing drastically with the modification of the period of good conduct, it remains to be seen whether the step towards easier insolvency regulation may also translate into more irresponsible borrowing.

4. Ireland: Consumers may stay bankrupt forever

Ireland is one of the European countries with rather stringent insolvency legislation for consumers, especially when compared to the neighbouring UK. Bankruptcy regulation dates from 1988/1989 and has not undergone major reforms ever since.[22]

Any debtor can apply for bankruptcy at the High Court; creditors may also submit a petition in case the debtor has not followed a payment summons within the previous three months. As is the case in the UK, once the court issues a bankruptcy order, all debtors' property, including his family home, is transferred to the trustee who will liquidate the assets for the benefit or the creditors. The amount of exempted 'essentials' that may be saved from liquidation is limited to a comparatively low value of €3,100 (or more if approved by court). In addition to the property sale, the High Court may also decide to appropriate salary or pensions. Creditors with secured claims, such as mortgages, may sell the asset that constitutes the security.

Once declared bankrupt, any debtor remains bankrupt until the High Court decides to have the debt relieved as Irish legislation does not foresee any automatic discharge. Debt relief may be granted only if certain conditions have been met, for example after creditors have been paid in full or after a period of good conduct of 12 years.[23]

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[20] Total credit to households per capita rose by 21% in the period 2003-2008: from GBP 14,500 to GBP 17,500 (from €19,200 to €22,200, with the respective end of year exchange rates).

All figures and calculations on consumer credit and mortgage loans in this Working Document are based on the ECRI Statistical Package. http://www.ecri.eu.

[21] The Insolvency Service (2007). *Attitudes to Bankruptcy Revisited* (http://www.insolvency.gov.uk/).

[22] Bankruptcy Act, 1988, and the Bankruptcy rules and forms, Order 76.

[23] In addition to those impositions, certain penalties apply, for instance the bankrupt is not allowed to manage a company, to hold elected representative office and his bankruptcy is permanently recorded – even after discharge – at the Bankruptcy Register.

All these requirements impose a heavy and costly burden upon consumers. Consequently, debtors often try to negotiate debt arrangements with their creditors in order to avoid official insolvency. Consumer bankruptcy procedures are seldom used in Ireland, as can be seen from the low number of actual adjudications: in 2007, only 5 persons were declared bankrupt, 10 were discharged from their debt, and those numbers have remained rather stable in recent years.

This is surprising indeed since Ireland has been experiencing a strong housing bubble with mortgage volumes having increased steadily from 20% of GDP (1998) to 65% (2007), and slightly decreasing again to 62% of GDP in 2008. The multiplication of outstanding debt has so far not led to more bankruptcy cases. Neither has the repossession activity by lenders increased, as has been confirmed by the Irish Banking Federation (IBF). Of the total number of mortgages used in 2008, only 0.01% of houses have been repossessed by creditors in Ireland; a very low rate when compared to the UK, where the repossession rate is 35 times higher.[24]

The relative good position of Irish creditors is mostly due to the renegotiations commonly attempted between debtors and creditors in order to solve financial difficulties before going to court. The Code of Practice on Mortgage Arrears that has been issued by the Irish Banking Federation urges lenders to consider renegotiation and to assist the borrowers as far as possible.[25]

Even though Irish insolvency legislation clearly gives priority to creditors' rights and represents a heavy burden to bankrupts, the requirements are painful enough to encourage debtors and creditors to find other solutions for recovery. Renegotiation plays an important role, and is actually strongly recommended in the official IBF code of conduct; consumers may therefore receive favourable treatment from the industry in order to sort out financing difficulties.

5. Germany: Six years to debt relief

The provisions of Germany's insolvency procedures can be placed somewhere between those of the UK and Ireland. The German Insolvency Regulation (*Insolvenzordnung)* covers company and consumer insolvency and entered into force on 1 January 1999. Its first and foremost aim is the best possible satisfaction of the creditors, at the same time giving the debtor the chance to recover from insolvency. For consumers, the major change and benefit of the new insolvency regulation of 1999 was the introduction of the possibility to have remaining debt discharged after a preceding period of good conduct. Any debtor is eligible to apply for the programme, given that he is insolvent or about to be.

German bankruptcy procedures foresee three phases: first, an obligatory out-of-court negotiation between the debtor and creditors, secondly, an in-court settlement phase and then possibly a third phase of a period of good conduct that is potentially followed by debt cancellation. It is remarkable that the initial out-of-court negotiation is compulsory, and only if no agreement has been reached during the first and second phase, may the debtor apply for admittance to the debt discharge (*Restschuldbefreiung*). If the court approves, the debtor has to fulfil several conditions over six years of good conduct, during which the sizeable part of the debtor's income is transferred to a trustee who then distributes it to the creditors. Home property may be seized as well. At the end of the six years, the court decides whether the residual debt is relieved, and such a discharge is only possible once every ten years.

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[24] The figures are taken from the IBF's website (http://www.ibf.ie).

[25] The IBF Code of Practice can be found at http://www.ibf.ie/pdfs/codes/mortgage_arrears.pdf.

Bankruptcy carries a strong stigma of failure in German society and the fear of financial ruin is very common, as has been stated in a report of 2002 to the European Commission.[26] The word for debt ('Schuld') already has a negative connotation attached to it, as not only does it translate to debt but also to 'guilt' and 'blame' – both meanings combined in one word.

Nevertheless, the number of insolvency proceedings has been increasing drastically in recent years. From 1999, when the new insolvency regulation entered into force, to 2007, the number of consumer bankruptcy cases that were accepted at court increased constantly from 1,634 to 103,085, an explosive development within a few years. 2008 marked the first year that consumer insolvency cases decreased to 95,730. In the same years, the total amount of credit to households rose by only 5% to €1,393 billions in 2008, an increase that is far from proportional to the development in bankruptcy filings. Applying for insolvency has surely become much more attractive to consumers with the introduction of the debt discharge in 1999.

According to a survey by Backert et al.[27] conducted in Germany in 2005/2006, the most important reasons by far for filing for insolvency were unemployment, "loss of financial overview" and divorce. Even though the unemployment rate has been going down in recent years to 7.3% in 2008, bankruptcy filings have been not de- but increasing. However the latest forecasts from the IMF estimate that unemployment will rise again to a possible 10.8% in 2010. If job loss is indeed the primary reason for consumer insolvency applications, consequently, the estimated rise in unemployment is likely to lead to more consumer insolvency filings. Nevertheless, creditors in Germany are not in such a precarious position, as they may expect some form of contribution from debtors during the prescribed six years of good conduct.

6. France: Debt discharge gains importance

Some aspects of the French insolvency procedure are comparable to the German system, for instance the possibility of out-of-court settlement as well as debt discharge after a period of good conduct. Consumer insolvency regulation was introduced in France in 1989, with a modification of the Consumption Code (*Code de la consommation*). The initial approach only provided for the option of debt settlement plans; partial and total debt discharge was not included until another amendment to the code in 1998, in order to respond to the increasing importance of private over-indebtedness. The code is currently being revised and likely to be modified again in 2009/2010 with the aim of providing for better consumer protection, fostering responsible lending and implementing the European consumer credit directive of 2008.

If consumers find themselves in a situation of over-indebtedness – defined as the impossibility of meeting debt obligations – they may refer to the 'household debt commission,' situated at the French Central Bank, to open procedure.[28] The request is likely to be accepted as long as the over-indebtedness is permanent and not due to temporary circumstances, and the declaration has been made in good faith. There is no cost associated to the application. The commission then assesses the level of indebtedness and decides between two procedures: either the negotiation of

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[26] Philippe & Partners (2002), *Bankruptcy and a fresh start: Stigma on failure and legal consequences of bankruptcy* (available at http://ec.europa.eu/enterprise/entrepreneurship/sme2chance/doc/report_germ.pdf).

[27] W. Backert, D. Brock, G. Lechner and K. Maischatz (2007), *Bankruptcy in Germany: Filing Rates and the People behind the numbers*, paper prepared for the 2007 Joint Meetings of The Law and Society Association and The Research Committee on Sociology of Law (ISA) at Humboldt University, Berlin, Germany.

[28] The over-indebtedness commission is made up of representatives from the prefecture, a consumer association, a credit institute, the treasury, the tax service, the Banque de France, as well as a lawyer and social worker. The aim of the commission is to reach a debt settlement agreement between the debtor and creditors.

a settlement plan or the “personal reestablishment” procedure. The former is a negotiated amicable settlement proposition by the commission that may last up to 10 years. For this plan to be effective, it needs approval by the debtor and the principal creditors.

If no agreement can be reached, the commission may propose a moratorium of two years,[29] after which the case will be reassessed. It can also make recommendations that may be imposed by court, for instance the rescheduling and reduction of debt. If, after reassessment of the case, the debtor's situation is still hopeless, the commission may advise the opening of the “personal reestablishment” procedure in court. This step entails either an obligatory settlement plan imposed by the judge or the liquidation of the debtor’s assets. The settlement plan may again have a maximum length of 10 years; however, practice shows that in half of the cases such plan does not exceed 5 years.[30] If the judge decides to have the property sold, the debtor may nevertheless keep a share of his assets and of his income in order to cover his living expenses. His home may be subject to foreclosure. At the conclusion of the reestablishment procedure – which is either after the settlement plan or directly after liquidation – the debtor may enjoy partial or total debt discharge.

As is the case in other European countries, there is a strong focus on negotiating an amicable settlement in France before further steps in the bankruptcy procedure are taken. In fact, in 2008, 159,967 applications were admitted to the household debt commission and 87,673 amicable settlement plans were negotiated, which is more than half the number of newly admitted cases. Yet, it can be observed that the number of amicable settlement plans as a share of admitted files used to be higher, ranging between 63-69% for the years 1998-2003. This is most likely due to the introduction of the “personal reestablishment” procedure in 2004, which facilitates debt discharge imposed by the judge. Since 2004, the number of cases admitted to personal reestablishment has doubled from 16,321 to 33,378 in 2008, while the total number of cases admitted has only increased by 4% for the same years.

According to a report by an enquiry commission at the French Senate,[31] there has been a shift in causes of over-indebtedness in the past ten years from ‘active over-indebtedness’ through irresponsible borrowing, over-consumption and costly accommodation, to ‘passive over-indebtedness’ because of a decrease in resources, for instance through job loss, illness or divorce.[32] These developments made amendments to bankruptcy law necessary at the turn of the century. In fact, investigations published by the Banque de France in 2001, 2004 and 2007 show that while 64% of over-indebtedness were classified as ‘passive’ in 2001, this share increased throughout the years to 75% in 2007.[33] For all three investigations, unemployment turned out to be the primary reason for over-indebtedness: in 2007, 32% of individuals quoted unemployment as the cause of their unfortunate situation, while divorce (15%), too much credit (14%) and illness (11%) were cited much less.

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[29] The moratorium implies a suspension of debt repayment and a reassessment of the case by the commission after two years.

[30] Source: Enquête typologique 2007 sur le surendettement, Banque de France.

[31] Source: Rapport n° 447 (2008-2009) of Senator Philippe Dominati.

[32] “Active over-indebtedness” comprises the following causes: too much credit, mismanagement, costly accommodation, excess charges and other, while “passive over-indebtedness” involves job loss/unemployment, separation/divorce, illness/accident, declining resources, deaths and other.

[33] The investigations were based on the debtors' applications submitted to the household debt commissions. All publications can be found at the website of the Banque de France (http://www.banque-france.fr).

These results are in line with the outcomes of the previously mentioned surveys that had been carried out in Germany and the US, demonstrating that reasons for over-indebtedness are comparable across several countries. They also confirm the positive correlation between unemployment and over-indebtedness, meaning that the country is likely to see more insolvency filings with a rising unemployment rate. Considering the unemployment rate forecast for France, higher over-indebtedness and more bankruptcy cases are likely to come up, since the rate is estimated to rise by 2% to 9.6% in 2009.[34]

7. Spain: No debt discharge possible

In Spain, consumer bankruptcy started being regulated only a few years ago, with the Law of 9 July 2003 (*Ley 22-2003, de 9 de julio, Concursal*). Before, insolvency legislation was limited to companies only. Any debtor who is (about to be) insolvent may file for bankruptcy at a commercial court. Creditors may do so as well, but have to prove that the debtor is insolvent. In general, insolvency proceedings do not affect creditors whose claims are secured by collateral.

At the beginning of the procedure, an inventory of the debtor's assets is established, and then a possible settlement plan is being discussed. For consumers, two outcomes of the settlement plan are possible: (a) a reduction of the debt (max. half of the amount) or (b) an extension of the payment period (max. five years). Liquidation of assets is primarily provided for business insolvency. In contrast to the other countries outlined above, Spanish legislation does not foresee a debt discharge for consumers. This clearly rules out a fresh start for consumers that would be given by a debt relief.

According to Professor Javier Arias Varona, Universidad Rey Juan Carlos in Madrid, two aspects are important in the discussion of the absence of a consumers' discharge: first, consumer indebtedness was traditionally much lower in Spain than in other European countries[35] (see Figure 3 below). Furthermore, as is the case in Ireland, the UK and the US, Spanish consumers are mostly indebted with mortgage credits, hence loans backed by collateral, where creditors may enforce their rights. Secondly, Professor Varona points to the fact that Spain did not have a procedure for consumer insolvency in place before, and after decades of discussions, passing that law already implied a major change, so people were paying less attention to the request of including the possibility debt discharge as well.

The non-existence of consumer bankruptcy procedures before 2004 is reflected in the low filing numbers as well. In 2005, only 60 individuals without a business activity applied for insolvency procedures. This number rose to 96 (2007), jumped to 374 (2008) and even reached 200 consumer bankruptcy filings in the 1st quarter of 2009.[36] These numbers are extremely low, compared to the million consumer insolvency filings in the US for 2008, nevertheless a strong upward trend can be observed for the recent months of the crisis.

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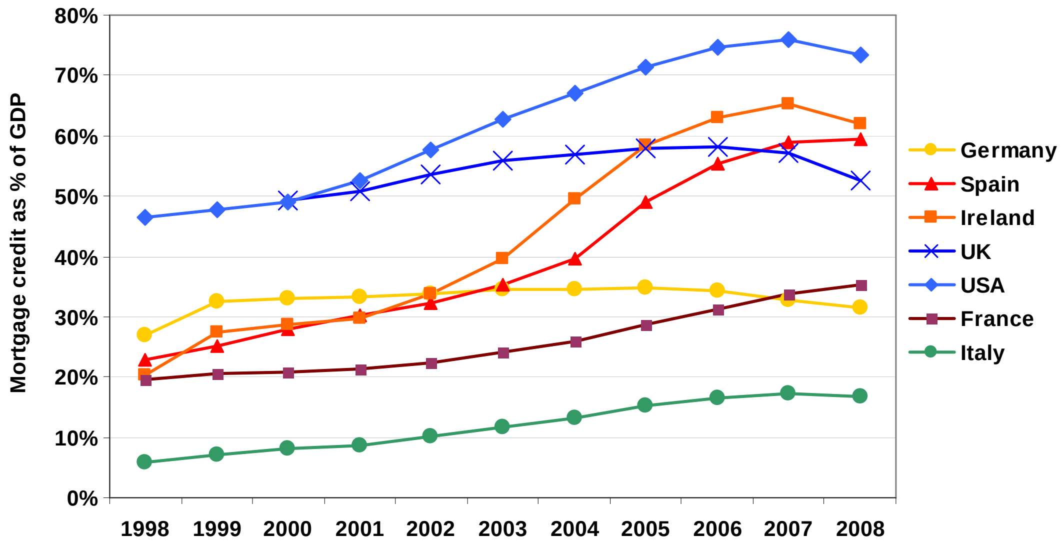
[34] Source: IMF World Economic Outlook Database April 2009.

[35] On Credit Slips: "Consumer Bankruptcy in Europe (II): Spain is Different!" (http://www.creditslips.org/creditslips/2007/07/consumer-bank-2.html).

[36] Numbers of individual insolvency filings are taken from the Spanish Instituto Nacional de Estadística (http://www.ine.es).

Figure 3. Mortgage credit as % of GDP



Source: ECRI Statistical Package 2009.

As has been the case in Ireland, Spain has experienced a housing bubble, as a result of low interest rates, economic growth and an increase in demand for housing. The statistics for recent years show that mortgage credit per capita (and also total household credit) has grown significantly. The volume of home loans that are delinquent for more than 3 months was at €0.9 billion in 2004, slowly rising to €4.2 billion in 2007, and then jumping to €14.8 billion in 2008.[37] The total impairment losses at banks reached €16.2 billion in 2008, around four times the value of 2005.

Regardless of the housing bubble and the strong increase of default on mortgage loans, the massive jump in the number of households experiencing payment difficulties may not necessarily result in higher requests for bankruptcy. Since housing loans are not obligatorily included in insolvency proceedings, creditors may exercise their right to enforce their claims. In those cases, insolvency procedures may not suit individuals that are primarily indebted with mortgage debt, as the provisions do not represent any relief for them, because creditors can still exercise their right to the collateral. Besides, the losses that creditors may fear from consumers' filings for bankruptcy are limited, since an entire debt discharge is not foreseen under Spanish legislation.

8. Italy: No consumer insolvency legislation

The only larger EU Member State that does not have any consumer insolvency legislation in place is Italy. The introduction of a bankruptcy law for individuals has been on the agenda for several years and a project of law is currently being discussed at the Senate. It foresees an amendment of the Italian usury law in order to include a formalized consumer insolvency

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[37] Source: Banco de Espana (http://www.bde.es).

procedure.[38] The provisions that are currently on the table are similar to the Spanish approach, where consumers' debt is being restructured over a settlement plan of a maximum 5 years.

The legislation that is currently being applied in the case of consumer non-payment of loans is the Italian Civil Code. According to this code, creditors may file for enforcement of their claims as soon as debts are due. The enforcement may then be carried out through wage garnishments and distraints of the debtor's assets, including his home. When it comes to non-payment of outstanding loans, the level of consumer protection is therefore very low in Italy. The debtor has little chance to defend himself if he is not able to make the payments.

9. Conclusions

This Working Document takes a comparative look at insolvency regulation in the US and Europe, and concludes that the differences are indeed striking. Table A1 in the Annex gives an overview of the salient features of insolvency laws in effect in selected European countries and the United States. As can be seen in the table, the differences relate to many aspects, for instance the purpose and aim of the laws. Whereas the US focuses on a fresh start and clean slate for consumers, European insolvency legislation mostly aims at the satisfaction of creditors' claims. In the context of the financial crisis, it is remarkable that lax insolvency legislation in the US has not prevented credit providers from giving out easy loans. Apparently, the severe limitations of creditors' rights to recuperate outstanding loans did not have much effect on US lending practices, at least not before the collapse of the subprime credit system.

In Europe, the UK legislation can be considered to be the most 'consumer-friendly;' nevertheless, consumers' property is a long way from being as protected as in the US. Creditors therefore have more possibilities to enforce their claims. It is common under several European insolvency laws that debtors have to give up most of their property – including their homes – in order to serve creditors' claims (see Table A1). Even though the regulations on liquidation of assets and exemption provisions vary across European countries, interest rates are not strongly affected by those differences. As is the case in the US, interest rates for consumer loans and mortgages are similar across the above outlined states; national insolvency regulation does not appear to have a strong part in interest rate calculation.[39]

In addition to giving up most of their property, European debtors typically also have to undergo a period of good conduct with a settlement plan to make a contribution to debt service. As has been remarked by Niemi-Kiesiläinen,[40] these aspects attach some moral attributes from the debtors' side to insolvency procedures in Europe, because debtors have to make an effort and show good intent.

In all the countries outlined above, an increasing number of consumer bankruptcy filings can be observed. Due to widely differing legislation, one needs to be cautious in comparing absolute numbers for insolvency filings, since this can easily lead to misinterpretations and a distorted picture. National statistics have to be put in the national context and interpreted accordingly. Table 1 below presents the number of insolvency cases across the six countries discussed above. It needs to be stressed that for the first four countries, the numbers are relative (that is, per

[38] The document "Disegno di legge" of 30 April 2008 can be found on the Italian Senate's website (http://www.senato.it/leg/16/BGT/Schede/Ddliter/testi/29935_testi.htm).

[39] Comparing lenders' interest rates across countries always remains difficult, since many factors play a role, such as the terms and conditions of credit contracts, as well as the typical repayment period, interest rate determination and additional fees.

[40] J. Niemi-Kiesiläinen (1999), "Consumer bankruptcy in comparison: Do we cure a market failure or a social problem?", *Osgoode Hall Law Journal* 37 (1&2), pp. 473-503.

10,000 inhabitants), while for Spain and Ireland absolute figures are indicated due to the low numbers of filings. Whereas the number of insolvency cases has been growing slowly in Ireland, the pace and also the relative numbers have been much higher in the US, the UK and Germany, as can be seen in Table 1. In the US, property protection and exemption levels play an important role when making the decision to file. In Germany, the introduction of consumer debt discharge in 1999 certainly made insolvency more appealing. For the UK, numbers have been rising after the shortage of the period of good conduct in 2004. In France, the total number of applications admitted to the debt restructuring process has remained stable over the past few years; however, there has been a shift from amicable settlement plans to compulsory plans that are more likely to end in partial or total debt discharge. Spanish figures are also comparatively low, but consumer insolvency filings have experienced a significant increase since the introduction of the regulation in 2004.

Table 1. Insolvency cases across selected countries

	1999	**2000**	**2001**	**2002**	**2003**	**2004**	**2005**	**2006**	**2007**	**2008**
Insolvency cases per 10,000 inhabitants										
USA	46	43	51	53	56	53	69	20	27	35
England and Wales	6	6	6	6	7	9	13	20	20	20
Germany	<1	1	1	2	4	6	8	11	13	12
France	18	21	20	20	24	25	26	26	25	26
Absolute numbers										
Spain						4	60	53	96	374
Ireland		4	6	4	5	5	9	10	5	

*Note*s: The US figures indicate the total number of bankruptcy filings at the US Courts. The statistics for England and Wales include bankruptcy orders and debt arrangements between debtors and creditors. German figures comprise all insolvency procedures that were opened at court (no out-of-court settlement plans), while the French totals indicate amicable and judicial settlement plans. For Spain, the data for 2004 refer to the 4th quarter only, when the new insolvency legislation entered into force. The Irish data indicate the number of adjudications per year.

Sources: US Courts, UK Insolvency Service, German Federal Statistical Office, French Central Bank, Spanish National Statistics Institute and Irish Courts Service.

The procedure of renegotiating the loan between creditors and debtors in order to agree on a new settlement plan with new conditions is much more widespread in Europe than in the US (see Table A1). While it is compulsory in Germany to have out-of-court discussions, Irish debtors tend to follow this practice voluntarily, since the status of being bankrupt carries major disadvantages. The number of Irish consumer bankruptcies is consequently very low, even during the housing bubble and crisis.

One could of course argue that the US should also support the renegotiating process as a way to resolve difficulties between debtors and creditors. Re-negotiation certainly would be feasible for certain kinds of debt, but in the case of mortgages, this might be very difficult to realise. Many US mortgages have been repackaged into MBS. Once these are created, the underlying conditions of the loans may not be touched, or may only be modified for a small portion under strict rules that have been agreed upon beforehand. This almost eliminates the possibility of renegotiating the terms and conditions of mortgage loans in the US, as has been pointed out by

White.[41] The same problem could arise with any other type of credit that has been re-packaged into asset-backed securities (ASB). In this context, credit card loans are of special interest since default rates have been rising significantly and many of these loans – just like mortgages – have been packaged into ASB.[42]

When it comes to cancelling debt, the UK is one of the few countries in which a discharge is automatic (see Table A1), so no court decision is necessary to finalise the judgement on debt relief. The contrary is the case in neighbouring Ireland, where debtors officially stay insolvent for 12 years or even throughout their whole lives, if the court has not decided otherwise. When the discharge has to be approved by court, the consumer has a greater incentive to strictly follow the rules of the repayment plan, knowing that his behaviour will be evaluated at the end, which is evidently only in the creditors' interest as well. In general, European debtors must fulfil more conditions in order to obtain debt relief, and it is typically the case that the insolvent consumer still has to make some kind of payment in order to receive debt relief. Discharge is only possible with certain costs and efforts; it is not for free.

One significant reason for people to file for insolvency is unemployment, as has been shown by surveys in the US, France and Germany. This factor is even more important during the current crisis, since unemployment numbers are rising and are likely to translate into more bankruptcy cases. The delinquency numbers for all types of loans are already increasing at the moment, as has been announced by central banks in the US and Spain,[43] and are likely to keep rising if people lose jobs and lose income.

It seems that after housing loans, the credit card sector has been hit the hardest. Credit card companies in the US have been announcing very pessimistic forecasts for repayment rates for 2009/2010. These dangers are taken very seriously, as the US government passed an Act[44] in May 2009 to protect American credit card holders and avoid another collapse. The rising delinquency and default rates on credit cards in the US make it – again – less likely to decrease bankruptcy filings in the near future. The problem is aggravated by the fact that many credit card loans in the US have been repackaged into ASB, which makes it difficult if not impossible to renegotiate the underlying terms of the loan contract. What the consequences are and whether these developments could imply a credit card bust remains to be seen.

For the European countries outlined above, there are certainly similarities between consumer insolvency laws, but it also needs to be stressed that there are still a few European states that do not have any bankruptcy legislation for individuals, Italy being one of them. There is no common consumer insolvency approach at EU level; the only piece of EU legislation that addresses bankruptcy is the Regulation on insolvency proceedings, which sets up a system for coordination of bankruptcy cases that came into force in 2002. However, it deals mainly with business bankruptcies where the insolvent firm and its creditors are located in different Member States, in order to ensure that the parties involved have no incentive to transfer court proceedings or their assets to a different country to obtain favourable conditions.

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[41] M. White (2008), *Bankruptcy: past puzzles, recent reforms, and the mortgage crisis*, National Bureau of Economic Research Working Paper No. 14549.

[42] Data on securitization volumes in the US and European countries is published by the European Securitization Forum in its Securitization Data Report (http://www.europeansecuritisation.com).

[43] It should be remarked that not all central banks record official default rates, only a few have this requirement.

[44] The Credit Card Accountability, Responsibility, and Disclosure (CARD) Act of 2009 includes measures banning unfair interest rate increases and requiring the use of plain language in credit contracts.

Considering the great differences in consumer insolvency approaches and consumer credit patterns in the EU, little room is left for common legislation. The basic question that lies at the heart of consumer insolvency procedures is whether debtors' or creditors' rights should be enhanced, and priorities here have been different across Member States. Yet, in the context of consumer protection, there is certainly a strong argument to have a guideline or best practice for consumer insolvency at EU level. Strenuous efforts have been made to integrate markets for retail financial services within the EU. The Consumer Credit Directive includes several provisions for common rules in Europe, such as the standardised information sheet, the right of withdrawal and early repayment. However, those harmonisation efforts focus on the stages where individuals enter into a credit agreement or are repaying it, but no attention has been paid to having some form of standardised consumer protection at the possible last stage, where a debtor may find himself in default and file for insolvency. The harmonisation effort therefore is not complete, as it leaves out the later stages of the whole possible lifecycle of consumer credits. However, in order to address bankruptcy topics, other issues need to be sorted out first, such as a common definition of over-indebtedness or non-performing loans.

One interesting observation on insolvency legislations is the way in which they have been modified recently. Whereas the bankruptcy law in the US has been amended to be more restrictive, the opposite is the case on this side of the Atlantic. The UK has reduced the period of good conduct from 3 years to 12 months; Germany has done so from 7 to 6 years, and France introduced total debt discharge in 2004. In the same year, Spain has for the first time introduced legislation for consumer insolvency in order to support individual debtors. And Italy is still in the process of discussing the introduction of individual bankruptcy proceeding. While the trend in the US appears to be to restrict lax legislation, European laws are moving towards stronger consumer protection, even though the satisfaction of creditors remains the priority in insolvency proceedings. Deciding which approach is the right one remains difficult, as it is mostly a question of setting priorities: consumer protection against creditors' rights, or encouraging consumer spending against costly restrictive repayment plans.

Annex

Table A1. Overview of insolvency laws in selected European countries and the United States

Country	Legislation	Purpose	Eligibility	Extra-judicial settlement
USA	Bankruptcy Code (11th Chapter of the United States Code)	Firstly, to give an honest debtor a 'fresh start' in life by relieving the debtor of most debts, and secondly, to repay creditors in an orderly manner to the extent that the debtor has property available for payment	**Chapter 7** Individual, partnership, corporation or other business entity, irrespective of the amount **Chapter 13** Any individual as long as unsecured debts are less than $336,900 and secured debts are less than $1,010,650; corporations and partnerships are not eligible	Not compulsory, not common
France	Code de la consummation	To address the situation of over-indebtedness of natural persons	Any well-intentioned debtor who cannot meet his personal debts	Depends on the applied insolvency procedure. Renegotiations are compulsory with the mostly applied procedure
Germany	Insolvenzordnung	To satisfy creditors' claims, while giving the honest debtor the opportunity to have remaining debts discharged	Any debtor who is (or is about to be) insolvent	Yes, compulsory
Ireland	Bankruptcy Act of 1988	To satisfy creditors' claims by selling debtors' assets	Any debtor who has assets available that are sufficient to produce at least €1,900.	Very common, not compulsory
Spain	Ley 22-2003, de 9 de julio, Concursal	To satisfy creditors' claims while protecting the debtor from the consequences of over-indebtedness	Any debtor who is (or is about to be) insolvent	Not compulsory
England and Wales	Insolvency Act and Insolvency Rules of 1986	To free the debtor from overwhelming debt, while making sure that the assets are shared out fairly among the creditors	Any debtor who is insolvent	Not compulsory

Table A1. Overview of insolvency laws (cont.)

Country	Liquidation and foreclosure	Exemption	Good conduct and discharge	Restrictions and punishments
USA	**Chapter 7** Liquidation and foreclosure possible, depends on the exemption law of each state **Chapter 13** No liquidation foreseen. The debtor keeps his property and repays debt over time. Creditors with secured claims have the right to receive at least the value of the collateral, and may therefore proceed to foreclosure	**Chapter 7** Exemption law is regulated at the state level, but some states allow choosing between state and federal exemption provisions. Exemption laws vary widely and typically provide for a share of home and other personal property to be exempted **Chapter 13** Debtors can typically keep their property	**Chapter 7** No period of good conduct; immediate discharge, typically after 4 months **Chapter 13** After the debt settlement plan of 3-5 years, court may decide to have remaining debt discharged. Some debts are not discharged, including certain long term obligations, home mortgages, debts for alimony or taxes	
France	Liquidation is possible, if imposed by judge	Part of debtor's property and income are exempted to provide for enough to cover living expense	Debt settlement plan of max. 10 years, but typically 5 years. Partial and total debt discharge are possible	Names recorded at the National Database on Household Credit Repayment Incidents (FICP)
Germany	Liquidation is possible, if imposed by judge	Part of debtor's property and income are exempted to assure a life in dignity	Period of good conduct of 6 years, possibly followed by a debt discharge	A register at court stores the names of insolvent debtors for three years
Ireland	Yes. All property (including the family home) is transferred to a trustee, with the exception of 'necessaries' up to a value of €3,100. The court may decide to appropriate income or pension for the benefit of your creditors	Essentials up to a value of €3,100 or more if approved by court	Legislation does not foresee automatic discharge. Discharge is possible in several cases when certain conditions are met, e.g. debt has been repaid, unsecured creditors agree to have a discharge or after a period of good conduct of 12 years	Names recorded at the Bankruptcy Register. Names include the discharged and are not removed from records Restrictions concerning managing and directing a company. Bankrupts may not hold certain public offices
Spain	Liquidation is possible, but mostly for companies. Securitized claims may be enforced	Exemptions not explicitly mentioned	not applicable	Possible in case the debtor does not follow the decisions of the court
England and Wales	Yes. All assets (including the family home) are transferred to a trustee	Essentials and tools of the trade	Automatic discharge after 12 months	Restrictions concerning obtaining new credit, carrying out business or managing a company. The bankrupt may not hold certain public offices

Source: Own compilation based on the legislation of the different countries.

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