DEBT, BORROWING AND OVER-INDEBTEDNESS: A COUNTRY-LEVEL MONITORING FRAMEWORK

SUMMARY

Debt is a double-edged sword: it can lead to economic growth, or crisis and over-indebtedness. The thin line dividing these two outcomes is difficult to define, and measures to detect when precisely the tipping point occurs are imperfect. While debt issues receive much attention at an EU level, supported by rich data sets of various cross-sections, there is less focus at a member country level, and still less on creating active policy arena to address the dangers related to debt over-extension in the economy and consumer over-borrowing. Indebtedness is in fact a complex social and economic phenomenon, which can only partially be understood through hard numbers and indicators. It affects huge numbers of people on a deeply personal level, impacting upon their well-being and ability to contribute to society. This paper explores various aspects of indebtedness as they relate policy, and advocates for a comprehensive monitoring system of policies and actions for tackling over-indebtedness on a macro-, meso- and country-level.

INTRODUCTION

Debt is a useful way to match supplies of money with demand: moving it away from creditors with an excess of it, and towards borrowers who are short of it. In good economic times, the broadening and deepening of credit markets is generally seen to spur growth through improved access to capital, since it gives ever more borrowers access to bigger loans at lower rates of interest. When “bad times” arrive, and economies fall into recession, this same debt suddenly transforms from a “ladder to prosperity” into a “slippery slope towards economic disaster”. This tipping point, when debt turns dangerous, is a critical moment for policy makers to monitor (to prevent its potential negative consequences), and take proactive steps all along before a potential crisis unfolds.

Debt in itself is a neutral thing: it is neither good nor bad, and a part of our economic reality. Debt is possibly the world’s oldest financial instrument – and has historically been the case that it must be paid in full and on time, regardless of the borrower’s circumstances. This distinguishes debt from other more flexible financial instruments (such as shares), which deliver only a cut of profit, whatever these might be.

Until the recent crisis, debt occupied little room in economic discussions even despite the rise of over-indebtedness over the past three decades. At the level of the economy as a whole, borrowers and lenders cancel each other out: every Euro owed by someone is also owed to someone. Thus, the liabilities of all

> **"How did you go bankrupt?" Bill asked. "Two ways," Mike said. "Gradually, and then suddenly."**
> **-Ernest Hemingway, *The Sun Also Rises***

debtors and assets of all creditors add up to zero, making debt seem trivial from the macroeconomic point of view.

Yet, as the data shows, debt is far from trivial, and it is not a "zero-sum game" for individual firms or households. Empirical studies highlight when debt becomes a dangerous force. Those risks differ depending on who owes debt (governments, households, firms or financial intermediaries) and what type (short- or long-term), as well as the currency in which they owe it. One recent study[1] finds that beyond a certain level, debt is bad for growth. For government debt, the threshold is around 85 per cent of GDP. The corporate debt threshold is closer to 90 per cent. The total household debt breakdown threshold appears to be around 85 per cent of GDP, although the impact is very difficult to estimate accurately.

Government policy can help prevent prolonged economic contractions by addressing the problem of excessive household debt. Bold household debt restructuring programs (e.g. in the USA in the 1930s, and in Iceland today), can significantly reduce debt repayment burdens and the number of household defaults and foreclosures. This helps avert self-reinforcing cycles of household defaults, further house price declines, and additional contractions in output.[2]

OVER-INDEBTEDNESS IN THE EU

An effective policy response to household over-indebtedness should be based on a balanced set of preventive, alleviative and rehabilitative measures.[3] To date, policy efforts within the EU have mainly focused on prevention. In April 2013, the European Parliament and the Council of the European Union agreed on rules to better protect consumers taking out residential mortgages. These rules demand that lenders provide a European Standardized Information Sheet to facilitate loan offer comparison, and the right to withdrawal from loan agreements within seven days. The EU is also improving the information available on over-indebtedness by releasing reports on household over-indebtedness and supporting research on the topic.[4]

Recognizing these efforts as a work in progress, it is worth noting that there are several important shortcomings of the state of knowledge and policy actions as they relate to over-indebtedness in the EU and its member states:

- Many studies are available, each taking a slightly different view on over-indebtedness, and typically recommending more research to be conducted. However, the marginal utility of further studies is diminishing. At this point, meta-analysis is needed to systematize common findings and recommendations of research undertaken to date, to clarify knowledge gaps and future research needs.

- Most studies are descriptive rather than analytical in nature: they describe over-indebtedness in various cross-sections, while providing little guidance for policy-makers.[5] Stronger analysis flowing from meta-analysis would help to focus the discussion towards actionable policies at a country level, as opposed to comparative studies across the EU zone.

- With the increasing number of studies and datasets, a "big data" problem emerges, making it is difficult to see what the data really means. There is a need for data reduction and visualization to address "data overload" which could help garner better insights to inform policy-making and develop predictive indicators of over-indebtedness.

- A tendency to avoid measures exacerbates the big data problem. While defining indebtedness is not straightforward (often leading to ambiguous measures), straying away from

[1] Cecchetti S., M. S. Mohanty and F. Zampolli (2011) *The real effects of debt*. BIS Working Papers, Basil.

[2] World Economic Outlook (2012): *Growth Resuming, Dangers Remain*. International Monetary Fund. **www.imf.org/external/pubs/ft/weo/2012/01/pdf/c3.pdf**

[3] Eurofound (2012), *Household debt advisory services in the European Union*, Dublin.

[4] European Foundation for the Improvement of Living and Working Conditions. (2013*). Household over-indebtedness in the EU: The role of informal debt*. Dublin.

[5] One noteworthy exception is a report: *Towards a common operational European definition of over-indebtedness study,* (CEPS-OEE-PFRC, 2009) which offers a number of policy actions.

common measures makes policy actions less effective, if at all effective.

- Several data sources are available, but not all EU countries are covered at the same level of data disaggregation, and few datasets offer inter-temporal comparisons; we need panel data with a complete set of indicators.
- We need in-depth analysis to see how indicators are inter-related, to better profile households and thus design better strategies that target relevant issues for different segments of the over-indebted population.

There is also considerable variation of interest in and reaction to actual (or potential) indebtedness issues among EU countries. Some, like Ireland, have taken proactive measures to deleverage debt and provide debt relief options for persons affected, but this is not the case in other member states.

Debt and over-indebtedness issues recently rose to prominence thanks to their role in the 2008 "Great Recession", that strained economies across Europe and globally, and put many households at risk of over-indebtedness and insolvency. The question is whether traditional policy measures are sufficient to tackle this problem, or new forms of policy interventions should be introduced. It is also key to consider who should pay for the excessive debt of consumers, when they need to be bailed out of debt and supported through public social programs.

DEFINING OVER-INDEBTEDNESS

Over-indebtedness in the EU is well-researched, and a good (yet insufficient) data foundation is available at different levels. Various efforts have defined and calibrated the incidence of debt and potential over-indebtedness, yet still we lack a common understanding of the phenomenon, and agreement on standard measures. There is also doubt whether such measures can be defined as over-indebtedness, which is a complex and dynamic phenomenon: the capacity to service debt is related to future revenue streams and wealth, which are uncertain and difficult to predict. Despite this lack of clarity, a study conducted for the European Commission in 2008[6] identified common elements in cross-country definitions. These were:

- Focus on household level finances
- All formal financial contracts considered, including mortgage and consumer credit commitments, utility and telephone bills as well as rent payments and other recurring contracted expenses
- Payment incapacity defined as an inability to meet recurring expenses
- A difficulty in quantifying a persistent inability to meet recurring expenses and asset value
- Inability to meet recurring expenses without reducing the living expense below the national minimum standard (usually the poverty line)
- Illiquidity defined as the inability to remedy the situation by recourse to assets.

These characteristics clearly indicate that (over-) indebtedness is a multidimensional, complex phenomenon which is unlikely to be captured by one synthetic measure, and which actually requires a set of measures that is appropriately designed and tested to reflect the various aspects of debt, taking into account local economic and social conditions.

WHY DOES HOUSEHOLD DEBT MATTER?

Household debt matters for a number of reasons that relate to national macroeconomic performance, as well as to the challenges facing individual households – and consequently govern-

[6] European Commission (2008) Towards a common operational European definition of over-indebtedness, European Commission: Directorate - General for Employment, Social Affairs and Equal Opportunities.

ments which are called upon to resolve these issues.

Household debt ratios are an important analytical tool, because they allow policy makers, analysts, economic researchers and others to evaluate households' financial situation and forecast final consumption expenditure.[7] Household consumption expenditure typically represents more than 60 per cent of a country's GDP; consequently, fluctuations in household expenditure patterns affect economic output performance. Rising household consumption expenditure levels generally stimulate the economy, whereas slower growth or declines have the opposite effect.

In general, individual spending and saving behavior is determined by the person's material and social needs, traditions, standard of living, existing debt levels, net worth and disposable income. Household consumption expenditure is therefore determined to an important degree by the extent of, and the actual and anticipated changes in, consumer income, as well as their ability to spend future income now by making use of credit.

It is critical to measure household debt appropriately in order to evaluate consumer spending behavior.[8]

FACETS OF OVER-INDEBTEDNESS

Debt, while understood on a general intuitive level, turns out to be a very difficult idea to conceptualize and analyze. The following is a short summary of a few key aspects of indebtedness that have important implications for monitoring and designing policies.

The "debt-free illusion

It is nearly impossible to operate debt-free in today's society. Households, firms and governments alike incur debt to varying degrees at various times, and debt underpins every economy. Therefore, it makes sense to talk about degrees of debt, from healthy and manageable to pervasive and destructive, on all levels. There is however, one key difference between firms and households (and government too): over-indebted firms, when they become insolvent, will typically go out of business. Households that experience over-indebtedness do not cease to exist, and have to find ways to cope and emerge from over-indebtedness in order to continue their existence.

This poses serious social and economic questions that have policy implications. While it is socially and morally justified to help those overburdened by debt, it is equally important to make sure that government policies do not encourage excessive borrowing when people can reasonably expect that they will be bailed out with little consequences for their own actions.

Tipping points

At low levels, debt is a good thing. It is a source of economic growth and stability. But, at high levels, private and public debt is bad, increasing volatility and retarding growth. In this sense, borrowing can be beneficial, so long as it is modest. Beyond a certain point, however, debt becomes dangerous and excessive. Household debt went over 100 per cent of GDP only twice over the last century (1929 and 2006), each time leading to massive financial crisis and economic recession. This distinction is equally true for the whole economy as it is for individual households, and it is possible to conduct studies to determine when debt stops being welfare-improving, and leads to household economic and social decline.

The household indebtedness level of 85 per cent of GDP as a measure of debt level is an important threshold that needs to be monitored and interpreted carefully.

[7] J W Prinsloo (2002), Household Debt, Wealth and Saving, SA Reserve Bank Quarterly Bulletin

[8] This view appears to be contrary to the findings of the European Consumer Debt Network and associated research. For example, recent research commissioned by DG Sanco on over-indebtedness states that there is little utility in defining indebtedness. See: *Study on the over-indebtedness of European households*. Civic Consulting. Stakeholder seminar, January 2013.

Pathways into debt

There are numerous factors that influence people to go into debt in excess of their current and even future resources, some of which are beyond the control of households; these include irrational consumer behavior that is exploited by financial institutions and retail sellers offering goods and services on credit. But financial institutions are not the only source of debt; people also borrow from friends and family, and informal debt plays an key role in a person's debt picture.

Over-indebtedness is a heterogeneous problem. Among the working poor and long-term unemployed, it usually arises from accumulated missed payments on utility and phone bills, and rent. The 2008 global financial crisis, with its lay-offs and reduced social benefits, has enlarged this group of poor people with debt problems, which has long formed a major part of the over-indebted cohort. However, much of the recent increase in over-indebtedness has come from within a different group: people who were in well-paid employment, and who lost their jobs and were left with large mortgages without the prospect of increasing their income in the near future.

Both between these groups and within them, there is great heterogeneity in the causes and consequences of over-indebtedness. It is important to distinguish between households that fall into debt through credit, from those with arrears and non-use of credit due to poverty and income loss. Different preventive measures should be designed for these different groups.

The typical economic explanation for indebtedness is demand-driven. According to the classic model of Modigliani, income levels are low for young adults beginning their working lives. Young families face many expenses tied to housing and children, but expecting their economic situation to improve over the years, they feel confident in borrowing to face those costs. Confidence in the future makes them less risk-adverse, which leads to indebtedness.

Other explanations of debt are linked with behavioral factors, such as people's tendency to consume, temptation and self-control issues. Over-confidence can influence borrowing, as people tend to underestimate the importance of future economic downturns. Financial literacy can influence the tendency of families towards higher leveraging. Another typical explanation can be described as 'keeping up with the Joneses', referring to the influence of peer pressure on the consumption propensity of families and individuals; group inequality and conspicuous consumption explain a large portion of debt, especially for poorer households.

A sociological interpretation of the phenomenon, which underlines the important role of financial innovations, is mostly supply-driven. The reason behind the increased leveraging of families is market liberalization, deregulation of the financial and banking sector, along with technological innovations like securitization and credit scoring.

There is no single way that a person becomes indebted, and socio-economic context is a key determining factor.

Misleading financial products and marketing

The behavior of financial institutions greatly contributes to client indebtedness through offering "toxic" products, misleading advertising and aggressive selling. While this is not true for all financial institutions, increasingly lenders exploit borrowers' low financial education levels and behavioral weaknesses through offering products that are not fully transparent, look very attractive and appealing but in reality entrap people in high-cost debt or a vicious debt cycle that is difficult to escape. Aggressive selling and misleading advertising only compound the problem. These practices act against the needs of clients who may end up with debt they never needed or could afford, and constitute the "dark" side of financial inclusion efforts trying to encourage people to use financial services.

Regulators should exert more scrutiny over financial products and sales tactics that can lead to unsustainable debt. While customers have free choice between providers, financial institutions are the "stronger" player, with power over less educated and behaviorally-vulnerable borrowers.

Scarcity and borrowing

Some individuals and households borrow because they lack enough money to survive, and credit can aid short-term cash flow. However, insufficient resources and generally low prospects for future income mean they are unable to fulfill their financial obligations, and consequently go deeper into debt. This scarcity-based indebtedness is driven to some extent by their basic needs (such as the need to pay rent or buy food), but also, as recent research[9] demonstrates, by the limited cognitive ability of poor people to make wise financial decisions when they experience uncertainty, worry and distress.

Being poor means coping not just with a shortfall of money, but also with a shortage of cognitive resources. Poor people are less capable of wise financial decisions not because of inherent traits, but because the very context of poverty imposes psychological overload[10] and impedes cognitive capacity ("cognitive tax"). This is true not only for low-income people, but for all individuals who, for whatever reason, find themselves "poor". Financial uncertainty has a strong cognitive impact on a person's ability to reason and make sound decisions. Poor people are more likely to borrow more, and borrow at less favorable rates as their abilities to process and analyze information may be impaired. (This tendency is compounded by the stark reality that the limited options of credit available to poor people are often more expensive than those available to the less-poor.) Over-indebtedness and poverty are therefore strongly correlated, and mutually-reinforcing, with cognitive limitations acting as an important intermediary.

Policy-makers rarely recognize these cognitive taxes; yet, research suggests that they should focus on reducing them. Simple interventions such as smart saving accounts, assistance with completing application forms, financial planning prompts, or even reminders about wise money management may be particularly helpful to poor people. Policy-makers should also recognize and respond to natural variation in an individuals' cognitive capacity. Many programs impose cognitive demands on indebted clients (putting them through training programs for example), which require additional cognitive resources. Such practices should be carefully planned and measured against clients' abilities to fully engage. Another important policy lesson is to provide assistance so as to reduce financial volatility of revenue: low income but stable contributes not only to economic stability but also enable greater cognitive resources allowing an individual to take actions to improve.

The psychological perspective of debt has important policy implications. First, policy-makers should beware of imposing cognitive taxes on the poor just as they avoid monetary taxes on the poor. Filling out long forms, preparing for lengthy interviews, deciphering new rules, or responding to complex incentives all consume cognitive resources.

Levels of indebtedness: Household debt burden

Falling into over-indebtedness is a gradual process; individuals and households may move in and out of debt at various times, or go deeper into debt until they become insolvent. These stages can be defined by the state of financial affairs of an individual or looking at the proportion of debt service amount to the overall income (*see table overleaf*).

It is important to observe how households move from one stage of debt to the other, and what factors contribute to their increasing indebtedness. This information will enrich the overall understanding of over-indebtedness, adding a dynamic dimension to the analysis.

Short-term, intermittent and chronic debtors

Another important aspect of indebtedness is its frequency and prevalence over time. As mentioned earlier, it is nearly impossible to live debt-free. Most people are short-term debtors, generally settling debts in a regular, predictable and timely

[9] Mullainathan, S. and E. Shafik, (2013) *Scarcity: Why Having Too Little Means So Much. Times Books*, New York

[10] Cf. John Read (2010), *Can Poverty Make you Mad?*, New Zealand Journal of Psychology Vol. 39, No. 2

	Stage	Indicator
1	Financial constraint	Sense of debt burden, high debt-to-income ratio
2	Inability to make timely debt repayments	Mortgage arrears, using hire-purchase and other loans to keep afloat
3	Inability to cover living expenses	Arrears on rent or utility bills
4	Personal bankruptcy	Level of debt exceeds assets

way. Others incur debt from time to time, becoming intermittent debtors while still others (however a minority), are permanently in debt – often living on the edge of personal bankruptcy and insolvency. Individuals and households from different socio-economic and ethnic backgrounds have different propensity towards incurring and remaining in debt.[11] The stereotypical "culture of debt" (related to certain individuals and families) has also been shown to be a more nuanced portrait of debtors that needs to explored and monitored. In this way, we need meaningful and deep socio-economic segmentation of debtors to design appropriate policy interventions, beyond the typical indicators.

When designing and implementing interventions, policy-makers should recall that socio-economic status and work effort are robust predictors of intermittent and chronic debt. People from low-income families are more likely than those in more affluent families to experience chronic or intermittent debt than they are to avoid debt. Getting money to lower-income families, through a politically acceptable formula related to income, and increasing work opportunities, is a viable option for families in any socio-economic bracket experiencing intermittent or chronic debt.

Measuring over-indebtedness

Measuring indebtedness and defining a certain level of debt as "over-indebtedness" is a difficult task; and maybe even an ill-fated one. However, there are objective and subjective measures that can provide proxies for indebtedness, which can guide policy-making.

Objective measures

Objectives measures of indebtedness (hard facts, ratios, etc.) are quantifiable and testable indicators of indebtedness that best capture "true" indebtedness. While there is no universal agreement on the choice of measures, the indicators broadly reflect three main aspects of over-indebtedness: making high payments relative to income, being in arrears, and making heavy use of credit.

Category	Indicator
Cost of servicing debt	Households spending more than 30 per cent of gross monthly income on total borrowing (secured or unsecured)
	Households spending more than 25 per cent of gross monthly income on unsecured repayment
	Households whose spending on total borrowing repayments puts them below the poverty line
Arrears	Households more than 2 months in arrears on a credit commitment or household bill
Number of loans	Household with 3 or more credit commitments

Source: D'Allessio, G. and S. Iezzi, (2013) *Household Over-Indebtedness. Definition and Measurements with Italian Data*. Bank of Italy.

Since over-indebtedness is a complex issue that is not amenable to one unique and unambiguous measure, it is suggested that all the indicators listed in Table 2 should be used to capture different aspects of the issue. Interpreted jointly, they should give a good overall picture of the situation. It is also important to test measures against country level data to assess which version of the indicator best represents the local situation. For example, while it has been proposed that the number of credit commitments should be four, tests on Italian data

[11] Caputo, Richard K. (2012) *Patterns and Predictors of Debt: A Panel Study, 1985-2008*, Journal of Sociology & Social Welfare, Volume XXXIX, Number 2

showed that three commitments results in the best predictive performance of the indicator.[12]

In addition, to properly measure the debt capacity, it is necessary to incorporate household assets that might be liquidated in case of default. While this approach is theoretically correct, it poses a range of practical problems and is difficult to apply. Valuing assets and selling them is complicated, and disposing of assets to settle debts is the least desirable outcome of borrowing.[13]

Another promising line of research (undertaken by the Bank of Norway) attempts to define the macro level sustainable household debt,[14] and offering two versions of the definition and measure. The narrow definition focuses on whether households are able and willing to service their debt, and evaluates households' debt servicing income, i.e. the income available for interest and principal payments (where debt servicing income is defined as post-tax income less consumption expenses). The wider definition assumes that the narrow definition holds, and in addition, a shock to or return to the equilibrium path of households' debt servicing income or interest rate should not cause a "below steady state" fall in consumption that threatens financial stability through firms' debt servicing capacity.[15] This research is in line with the approach taken by Cechetti *et al*.[16]

Both micro- and macro-level measures should be used to capture global household indebtedness and specific aspects of debt burden distribution that collectively inform policy actions.

Subjective measures

Subjective indicators of indebtedness (perception, awareness of bring in difficult position) are an alternative to objective measures which are difficult to calculate and interpret. Subjective measures rely on asking people whether they feel that they experience financial difficulties or face debt repayment challenges. Research using this approach[17] proved to be fairly robust, even though self-reported measures are prone to different interpretations by respondents about the meaning of over-indebtedness and financial difficulty.

Subjective measures have two important advantages: they signals the existence of a problem more directly than objective measures, which have to be interpreted and qualified, and they signal the existence of cognitive challenges (as described above) which cannot be detected using the objective measures.

Static and dynamic measures

Another way to analyze indebtedness is to take a dynamic view of the ability of an individual or household to incur debt safely by accounting for the future potential income and assets. This approach is in line with the life-cycle approach to household financing, which asserts that younger individuals borrow more at early stages of their lives to acquire assets (such as a house or education), and less later on in their careers when their income levels are higher and they can enjoy greater pay-offs from their wealth. Dynamic measures, in principle, could provide a more accurate view of debt capacity – but are fraught with uncertainty about future income and wealth. Future outlook is nevertheless the basis for educational loans and other financial products although dynamic measures are inherently difficult to construct.

Choice of measures

It is difficult to state which measure is a better predictor of indebtedness, and which requires empirical testing. Recall that although subjective measure based on individuals' self-reported statements, these can shed more light about the current state of affairs and perceptions about the future, while objective measures are backward-looking, documenting trends that have to be appropriately extrapolated and interpreted.

[12] D'Alessio G. and S. Iezzi (2013) *Household over-indebtedness: definition and measurement with Italian data.* Questioni di Economia e Finanza, Bank of Italy.
[13] See ibid. for discussion of over-indebtedness measures that incorporate wealth (assets).
[14] Lindquist, K. (2012) *Sustainable household debt: Towards an operational view and framework.* Norges Bank
[15] Ibid.
[16] See footnote 1.
[17] Betti G., Dourmashkin M., Rossi Y.P., (2007) *Consumer Over-Indebtedness in the EU: Measurement and Characteristics*, Journal of Economic Studies, Vol. 34 Issue 2.

DATA: TOO LITTLE OR TOO MUCH?

Data on various aspects of indebtedness within the EU appear to demonstrate the extent to which we may be experiencing the “big data problem”: too much data that is difficult to reconcile and fails to capture the “big picture” in a holistic, dynamic way. At the same, while available in principle, the data may not as accessible as possible in terms of physical access to information, as well as the way data is organized and presented. It appears that most data that is available on a regular basis quantitative in nature, drawn from national questionnaires on debt and debt burden. There is relatively less, and less systematic qualitative data available on subjective and personal perspectives of indebtedness and psychological underpinnings of the debt phenomenon.

We need a mix of quantitative and qualitative data collected in a systematic and time-consistent way to fully grasp the richness of the indebtedness question. We also need data analysis that makes sense of the richness of available data, and provides policymakers a clear picture of the current and potential future situation.

POLICY FRAMEWORK PROPOSAL

The Council of Europe[18] recommends that national governments should take a number of steps to address increasing indebtedness levels. A range of policy measures is proposed.

These measures can be categorized under three types:

- **Preventative measures** such as financial literacy, budgeting advice, responsible lending and information for borrowers
- **Remedial measures** such as protected earnings levels, debt adjustment, realistic repayment plans, extra-judicial settlements and legally-binding arrangements
- **Rehabilitative measures** such as debt write-offs, the right to a “fresh start” and a clean slate as a credit user.

Preventative policies are largely forward-looking, geared towards averting, *ex ante,* the indebtedness problem, while the others two are retrospective (*ex post*) measures that tackle existing problems. These should relate to problems on various levels:

- **Macro-level:** related to the actions that governments and regulators could undertake to prevent and/or correct the burden of over-indebtedness
- **Meso-level:** related to the behavior of financial institutions and other market players, whose actions have a bearing on individual and household indebtedness
- **Micro-level:** related to individuals affected (or potentially affected) by debt burden and the resulting socio-economic consequences.

Adding measures to be applied at these three different levels results in one coherent proposed policy framework (*see table below*).

Measures \ Levels	Macro	Meso	Micro
Ex ante	Preventative policies keeping household debt at sustainable levels	Measures guiding financial institutions and other credit-issuing organizations around responsible lending	Measures encouraging “nudging” consumers towards rational, responsible borrowing and money management
Ex post	Policies aimed at reducing debt when it reaches unsustainable levels	Remedial policies curbing the behavior of aggressive creditors	Policies aimed at resolving individual debt burden through mediation and debt management programs

[18] Council of Europe (2007) *Legal solutions to debt problems: Recommendation and explanatory memorandum*. Strasbourg.

We need *ex ante* and *ex post* policies on all three levels operating in conjunction to address the complex multi-dimensional problems of over-indebtedness within a country.

DEBT WATCH: MONITORING OVER-INDEBTEDNESS

Why monitoring is important

The need to monitor indebtedness in its various forms stems from the fact that debt has become a permanent feature of our economic lives. Living debt-free is practically very difficult, and rising debt is often the only way to manage our finances. Even more importantly, debt is a complex issue that permeates all aspects of our lives, and has profound consequences on people's well-being and ability to function in society. It is fundamentally a human issue that has an impact on our mental and physical condition, and therefore extends beyond the "impersonal" statistics and measures that try to capture the extent and incidence of indebtedness in an objective or subjective manner.

Therefore we need to consider debt not only in terms of the financial debt burden on an individual, and the debt on a macro level, but also as a broader category of the contemporary human condition. Measures and analysis of the size, scope and incidence of excessive debt should lead to a deeper analysis of broader consequences that accompany over-indebtedness and impoverishment, especially for low-income people who are inherently more prone to falling into the "debt trap".

Debt Watch

A proposed "Debt Watch" would systematically review national policies, actions and gaps in addressing over-indebtedness issues. Such a Watch should be independent and impartial, ensuring that it provides an objective perspective on the situation, and is in a position to voice concerns that may not be otherwise politically-acceptable or socially-popular in a particular context.

Who

Debt Watch could be managed either by an independent consumer rights organization, or as a separate body – either formally organized (for example as an EU-wide organization), or as an ad-hoc body evoked annually to conduct this watch-dog function. In either case, its credibility depends on maintaining its independence and political neutrality.

What

The scope of Debt Watch should be comprehensive, covering all aspects of the indebtedness issue:

Policies

- Are there appropriate policies in place on all levels (macro, meso and micro) to address the issues of indebtedness and excessive debt burden?
- Is indebtedness a policy issue that receives sufficient attention given its prevalence in a country?
- How current and adequate are these policies?
- Are they implemented, and evaluated for their effectiveness?
- Are there policies that run against the well-being of people, for example short-term debt promotion for economic growth gains or political reasons?
- Are economic policies assessed from the point of view of their potential impact on indebted people?
- Are policies related to over-indebtedness coordinated among various government bodies?
- Are there legal and/or regulatory gaps that need to be remedied to make the policy and regulatory framework effective and complete?

Definitions and Measures

- Is indebtedness and over-indebtedness defined?
- What measures are used and what is measured?

- Are these definitions in line with EU definitions and other measures used in the country?
- How is indebtedness measured? And by whom? Who is responsible for measuring indebtedness?
- Are measures tested against available data?

Data

- What data about indebtedness is collected? How often and at what level of granularity?
- How is this data available to policy-makers, interested stakeholders and the general public?
- Is this data analyzed and made understandable for policy-makers and others?
- Are there easy-to-understand indices and other similar preventative measures about indebtedness?
- What data set gaps need to be filled to provide a full and complete picture of the indebtedness situation in a country?
- Is qualitative data about the state of indebtedness and its impact on poor people collected?

Activities/actions

- What actions and activities (remedial, rehabilitative, etc.) are undertaken by government agencies to monitor the debt burden in society?
- Who is responsible for implementing various policies and activities? Is there one coordinating body that takes a holistic and comprehensive view of the over-indebtedness in a country?
- What activities are carried out by non-governmental and consumer organizations?
- How effective are these activities and how are they assessed?
- Are there social groups or other individuals/ households that are not targeted with either remedial or preventative actions?

Financial products

- What is the range of financial products available on the market?
- How often are new products offered?
- How easy is to understand available financial products?
- Do they appear to be correctly describing the salient features?
- Are they in line with the regulatory requirements?
- Are "toxic" financial products monitored and publicly identified?

Behavior of financial institutions

- Are financial institutions following responsible lending principles?
- Which practices appear to be conducive to aggressive selling and misleading marketing of financial products?
- Which financial institutions have the worst record in using bad lending practices?
- Which institutions contribute most to the indebtedness of the population?
- How do the regulators monitor the market conduct of financial institutions?

Education and advocacy

- Is there adequate information available about the dangers of debt to consumers?
- Is financial literacy promoted, and is debt a part of financial capability efforts?
- Are there effective advocacy efforts that have impact on government policies and creditor behavior?

Public information

- Is the general public aware of indebtedness levels and issues in the country? Have any public surveys or opinion polls been conducted to measure this?
- What public information is provided by key government agencies (e.g. ministries, central bank, etc.)?

- What information is provided by credit registries and in what form? How is this service publicized?
- Is the media interested and involved in reporting on indebtedness and debt burden issues in society?

Economic and social consequences of debt

- Is the level of household debt sustainable from the macroeconomic and individual household perspective?
- Who appears to be most affected by excessive debt burden? What are the trends in this regard?
- Is the social perception of, and attitude towards, debt changing, and if so – how?
- What social consequences of debt appear to be the most critical for individuals with debt burden and how are these addressed?

How

Monitoring tasks would be undertaken using a number of techniques: including policy assessment, surveys and research studies, to social media reviews to get a full perspective of the indebtedness situation in a society. The specific methods would be ultimately dictated by the scope of the watch body. We envision cross-disciplinary collaboration by lawyers, economists, sociologists, educators, and advocacy experts to create a comprehensive map of indebtedness. Results could be summarized in an annual report; findings should be widely communicated through the media, and used as guidance for policy-makers and social programs.

EU-wide collaboration

Once established on a country level, Debt Watch could become a collaborative platform across all EU countries that would encourage professional cooperation, exchange of perspectives and monitoring methodologies, sharing of research experience and results. This would enrich the state of knowledge and understanding of indebtedness issues – especially among the most vulnerable groups – to improve the effectiveness of policies and activities designed to mitigate the negative consequences of over-indebtedness.

As such, this EU-wide collaboration could lead to the creation of an independent voice to provide an objective, non-partisan picture of over-indebtedness in Europe. This could be an independent alternative to other reports and assessments that are commissioned and financed by the EU and other bodies.

CONCLUSIONS

A review of debt burden and over-indebtedness issues shows that debt is a very complex phenomenon, which has economic impact on growth, and a social impact on the well-being of individuals and households – that can be either positive or negative. A lot of research and data is available on the topic, and despite their shortcomings, these do offer insights into different aspects of indebtedness. What is missing is a higher level, "big picture" approach to consolidate these various strands of findings and policy initiatives, and provide higher-level guidance for policy-makers and advocacy groups. Debt Watch could perform this function on a country level, and collectively in the EU, and provide a much-needed consolidation of the rich informational base in a comprehensive and policy-oriented manner.

The **Microfinance Centre (MFC)**, based in Warsaw, Poland, is a regional microfinance resource center and network. It brings together 103 organizations (including 78 microfinance institutions, or MFIs) in 27 countries of Central Europe and Asia, serving over 800,000 low-income clients. MFC's goal is to promote balanced MFI performance, create informed and capable financial consumers, and build strong institutions. To that end, it conducts research and analysis, contributing to thought-leadership, provides technical assistance on best practice, and collaborates with NGOs, private, bilateral and unilateral funders, and policymakers. For more information, visit **www.mfc.org.pl** or email us at **microfinance@mfc.org.pl**.

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