



Finance Watch

Making finance serve society

October 2022

Root causes of household over-indebtedness



A Finance Watch policy brief

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Author: Emily Glantz, Peter Norwood

Editors: Ben Cuzzupe

Cover photo: Adobe Stock / Kevin

Graphics and typeset: Camila Dubois

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Finance Watch has received funding from the European Union to implement its work programme. There is no implied endorsement by the EU or the European Commission of Finance Watch's work, which remains the sole responsibility of Finance Watch.



**Co-funded by
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Root causes of household over-indebtedness

In the majority of the European Union (EU) Member States, household debt is used as a foundation upon which home life, careers and even wealth can be built. For many households and individuals, the acquisition of debt is simply a tool to smooth out the income curve, which is spread out across the life cycle.¹ For others, taking on debt opens up a trap door which can lead to long-term financial despair or over-indebtedness. In turn, over-indebtedness heightens the risk for social exclusion and “physical and psychological health problems”, which can even lead to suicide and take an intergenerational toll on dependent children.² At macro level, over-indebtedness creates direct and indirect social costs, threatens household resilience to external shocks and contributes to financial instability.



- 1 Giovanni D'Alessio and Stefano Iezzi, "[Household Over-Indebtedness: Definition and Measurement with Italian Data](#)," Bank of Italy Occasional Paper No. 149, (2013).
- 2 Richard Ahlström and Fredrik Tjulander, "[Insolvency syndrome: when over-indebtedness affects health and wellbeing](#)," Sheffield Political Economy Research Institute. (May 27, 2020).

I. Defining over-indebtedness

Despite EU efforts to cultivate a common concept, a shared definition of over-indebtedness remains elusive. A European Commission study appointed to make progress toward a common definition, however, finds four common threads linking national descriptions with over-indebtedness. They are typically described as:

(1) an issue of liquidity regarding income or other resources, that (2) impairs the payments of financial commitments over a (3) sustained period, unless (4) the standard of living is reduced below a reasonable level. Increased borrowing cannot resolve the situation.

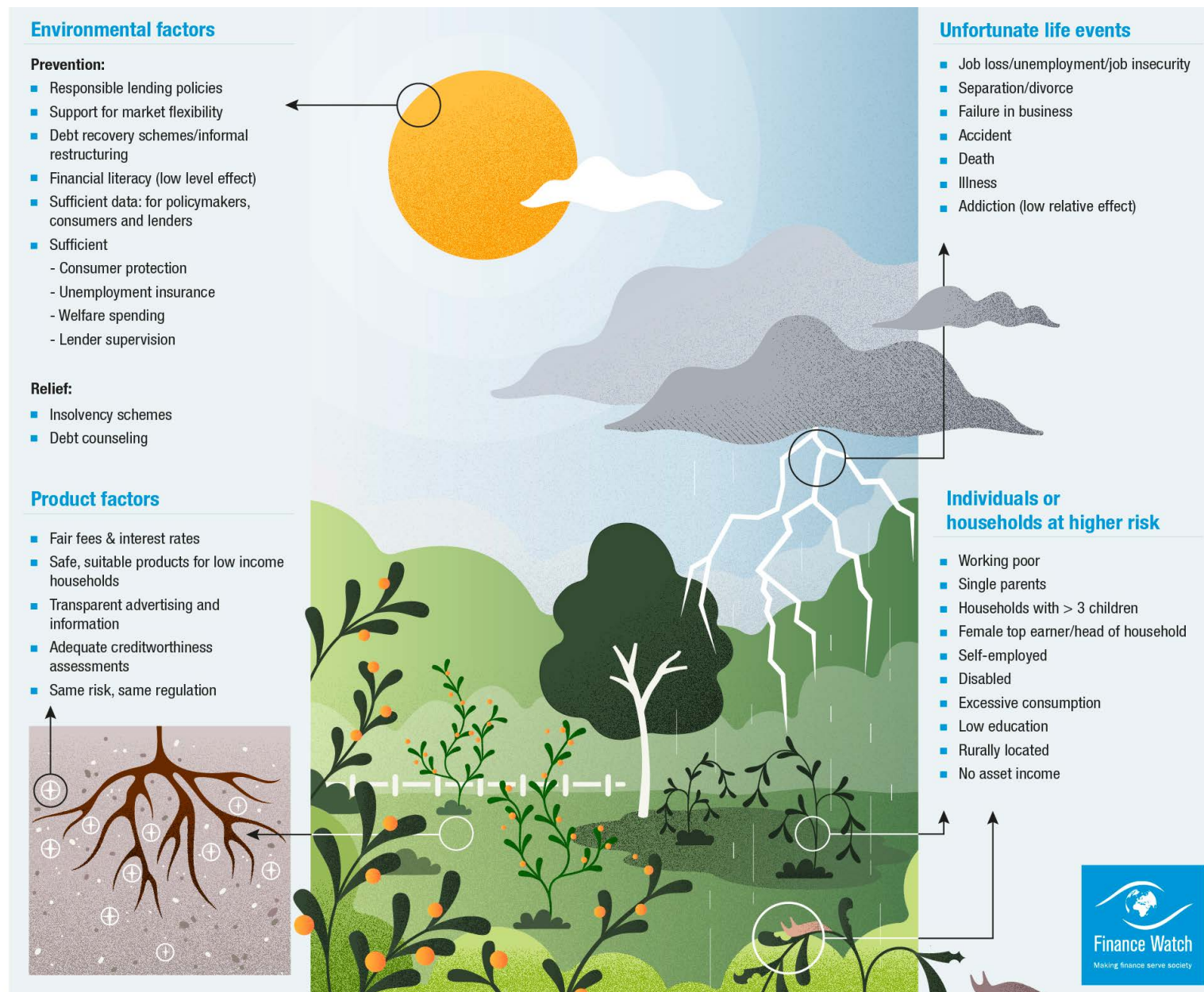
Additionally, the study recommends the household as the unit level of measurement under the assumption that resources are shared.³ Measurements of over-indebtedness also vary across borders, making it difficult to capture the true scope of the problem.

II. Method for establishing root causes of over-indebtedness

Through a literature review of publications examining over-indebtedness in the past decade, **this publication compiles an analysis of the phenomenon's root causes.** An overview of the types of individuals or households who are more likely to be vulnerable to over-indebtedness, will be followed by a summary of the major external factors influencing their circumstances. Finally, an outline of credit product characteristics and market practices are presented, highlighting the risks inherent in under-regulated products operating in markets with poor consumer protection. This review of root causes is in no way exhaustive. Over-indebtedness is a socially constructed phenomenon borne from a complex network of interactive factors which can vary from context to context. Understanding it completely would demand greater disaggregation in the collection of data within the EU and a much more nuanced, extensive examination of both that data and previous works.

³ Didier Davydoff et al. *Towards a common operational European definition of over-indebtedness*. European Commission. (February 2008).

A closer look at the over-indebtedness ecosystem



III. Internal factors – A garden variety of individuals and life circumstances

Vulnerable individuals & households

Certain trends in individual or household characteristics have been identified as eliciting a higher risk for encountering over-indebtedness. One such characteristic or group – painted with a broad stroke – is labeled “the working poor.” The working poor is diverse and comprises part-time, short-term contract or gig employees, the self-employed, low-work-intensity households, single earners, and single parents.⁴ Within the European Union, 85% of the current 9.2 million single parent households are headed by women.⁵ Generally speaking, households headed by women or with females as the top earner are at a greater risk for over-indebtedness. In addition, those facing increased risk include households or individuals with three or more children, those with disabilities, with low educational attainment, living in a rural location, struggling with excessive behaviors of consumption or economic mismanagement or living without income from assets. Intersectionality, or the layering of such traits, heightens the level of risk. Not all who can identify with any of these characteristics will become over-indebted, but destabilising events are more likely to push them over the edge.

Life circumstances or events

Certain people are more vulnerable, but anyone can find themselves in a situation of over-indebtedness when the balance between their financial commitments and income is substantially disturbed by certain life events.

While a significant number of over-indebted people have suffered a job loss or income insecurity, the separation or divorce of a couple, a failure in business, an accident, occurrence of illness (including addiction) or death of a family member are also events associated with leading to this unfortunate financial situation. The severity to which the event affects a household's situation, depends upon both the household and external societal characteristics.

IV. External factors – the environment and the winds of change

Regulatory & Market Structures

Like a garden without sufficient water, fertilizer and coverage from storms, a lack of adequate mechanisms in the external environment – whether at local, national, or international level – can put households at greater risk for over-indebtedness. When in place, **these mechanisms can provide households with shelter from the shock of life events or the effects of financial and economic crises.**

In regard to prevention, a high correlation exists between inadequate unemployment insurance - either in terms of duration or net replacement rate - and the risk for over-indebtedness.⁶

4 Olivier Jérusalmy, Paul Fox, Nicolas Herclin and Lin Mao. Financial exclusion: *Making the invisible visible*. Finance Watch. (2020).

5 European Institute for Gender Equality. *Poverty, gender and lone parents in the EU: Review of the Implementation of the Beijing Platform for Action*. (2016).

6 S. Angel and K. Heitzmann. *Over-indebtedness in Europe: The relevance of country-level variables for the over-indebtedness of private households*. Journal of European Social Policy, 25(3), 331-351.

Reductions in or inadequate levels of welfare spending, poor protection of wages and a lack of support for market flexibility can also erode household resilience against over-indebtedness. On the other hand, strong requirements for consumer protection and responsible lending policies in consumer protection regulation and adequate supervision of lenders and balanced debt recovery schemes – including the possibility for lenders and debtors to make an informal restructuring agreement – can all directly bolster household resilience.

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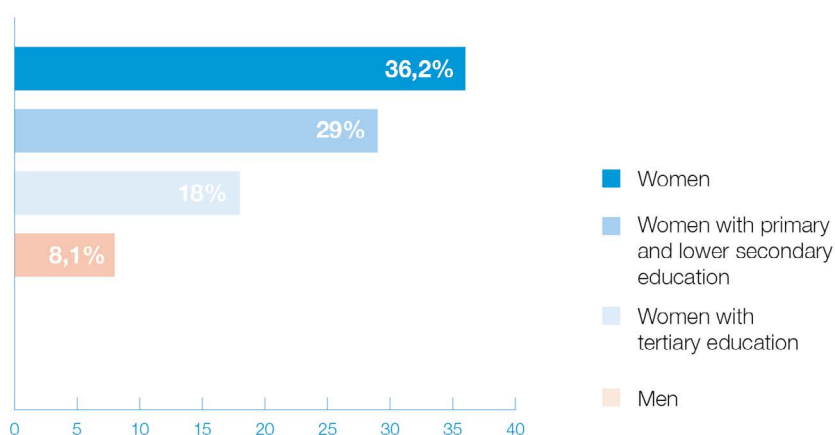
During times of economic crises such as the current cost-of-living crisis or the COVID crisis, the danger of consumers finding themselves in a situation of over-indebtedness in the absence of adequate retail financial services regulations and proper social safety nets or government measures is especially pronounced.

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The ongoing cost of living crisis, for example, has led to an increasing number of consumers turning to consumer credit to finance basic living expenses such as food.⁷ Consumers resorting to lending to make ends meet can quickly find themselves in a debt spiral if the lending market and credit products are not adequately regulated and they do not have alternative government support schemes they can turn to such as energy price caps, indexing of salaries or benefits on inflation.

Like changing the rules of the game, changing job or credit market characteristics can push certain individuals or even broad sectors of households into over-indebtedness. Substantial increases in housing costs and the changing nature of the job market – from full-time positions with benefits to part-time or inconsistent gig work – can expand the population of the working poor. Part-time and gig work is becoming increasingly popular and more prevalent among individuals of certain groups or with certain life circumstances such as women, single parents, and those with lower educational attainment. For instance, among women, part-time employment as a percentage of total employment stands at 36.2% while it is only 8.1% among men.⁸ This figure shrinks along with the level of education from 29% among those with primary and lower secondary education or less than 18% among those with tertiary education.⁹

Part-time employment as a percentage of total employment



7 Aggi Cantrill and Abhinav Ramnarayan. *Klarna Customers Seek Loans for Groceries as Debt Risk Rises*. Bloomberg (July 2022).

8 Eurostat. *Part-time employment as percentage of the total employment, by sex and age (%)*. European Commission. (2021).

9 Eurostat. *Full-time and part-time employment by sex, age and educational attainment level (1 000)*. European Commission. (2021).

The emergence of non-bank lenders as well as new unregulated credit products (this will be discussed in more detail in the section on ‘Product factors’), which elude existing regulations or supervision, also skew the game against households.

Though not a root cause, a lack of relief mechanisms for those who are already over-indebted prolongs the effect on the individual or household and limits their ability to productively participate in society. Debt counseling, debt discharge or insolvency schemes give individuals a second chance. In order for these services to be effective, quality standards, affordability and access must be established. Moreover, with regards to insolvency schemes specifically, schemes must enable debtors to make a fresh start by providing reasonable discharge periods and exemptions for certain assets and allow for a sufficient level of income during the discharge period to guarantee that the debtor can lead a dignified life. To date, there is a lack of a harmonised EU personal insolvency law embedding best practices to relieve household over-indebtedness, preventing over-indebted households to get the help they need. Most of the existing national schemes in the various EU member states are difficult for consumers to access and fail to provide debtors with a true fresh start. EU legislation implementing best practices are therefore needed to address these shortcomings.¹⁰

Data also impacts the way that over-indebtedness is measured and addressed on all levels. An inappropriate choice of measurement for risk-assessment and inadequate collection of disaggregated data at macro level, can leave policy makers blindsided by an impending wave of insolvent households. For lenders, collateral registries, valuation regimes and credit information systems can strengthen their ability to lend responsibly. Responsible lending, however, can only be guaranteed if lenders conduct a thorough assessment of the borrower’s household budget, encompassing payment account data comprising income, essential expenditures as well as existing credits and debts. Data shows that creditworthiness assessments (CWAs) that lenders carry out to check the affordability of a loan for a consumer are currently poor for all types of loans in the EU. An adequate CWA assesses a consumer’s household budget, which is based on data of the consumer’s income and essential expenditures, as well as ongoing credits and debts. However, in 62% of the cases a proper analysis of a household’s budget is not performed.¹¹

Moreover for borrowers, affordable financial advice, price comparison tools, debt cost calculators and payment reminders can improve their ability to manage finances. Currently, limitations in the quality and provision of product information hinder the ability of consumers, with 60% of secret shoppers seeking credit in the European Union reporting they were unable to make an informed choice at the time of signing. For the online credit market this number skyrockets to 72%.¹² Once credit has been purchased, even something as simple as a payment reminder can improve a household’s ability to manage their debts.¹³

In addition, strong investor protection rules preventing the mis-selling of investment products can help prevent consumers from finding themselves in a state of financial distress that could lead them to seek consumer credit. In particular during economic crises, consumers can be

10 Finance Watch. *From debtor prisons to being prisoners of debt*. January 2020.

11 Norwood and Antar, “*Tackling causes of over-indebtedness in the EU consumer credit market*”, Finance Watch, March 2022.

12 Peter Norwood and Alexander Molinari. *Consumer credit market malpractices uncovered*. Finance Watch. (February 2021).

13 Victor Stango and Jonathan Zinman. “*Limited and Varying Consumer Attention: Evidence from Shocks to the Salience of Bank Overdraft Fees*,” The Review of Financial Studies, 27(4): 990-1030. (April 2014).

tempted to take out risky investment products that promise fast and high returns. Users of these products can quickly find themselves in a dire financial situation, however, as investing in the ‘wrong’ products can lead to huge financial losses. Therefore, measures such as the banning of inducements that drive firms and intermediaries to mis-sell investment products that are unsuitable for certain retail investors is also important.¹⁴

Product factors

Financial products, such as consumer credit, can help consumers address their needs such as enabling them to purchase bigger household goods or a car which they may otherwise struggle to purchase. However, certain products, due their risky nature or business model can also lead to financial detriment or even over-indebtedness if they are not properly regulated.

In recent years, a number of new products have emerged in the EU consumer credit market such as buy-now-pay-later schemes (BNPLs), payday loans, deferred debit cards and leasing agreements with an option or obligation to purchase the good after the lease period ends. These types of consumer credit are mostly taken out by low-income and other vulnerable consumer groups and often total less than 200 euros. Because of their seemingly low value, they are often perceived as small value loans by lenders even though they are not low in value at all from the financial perspective of the mostly lower-income consumers purchasing them. These loans are highly risky as they have very high costs associated with them and are mostly unregulated.¹⁵ Further exacerbating this problem, some of these products are designed in a way that profits the lender if the consumer defaults, incentivising irresponsible lending.¹⁶ As a result of all of these factors, consumers are at high risk of becoming over-indebted when taking out these loans and often have to take out multiple loans to finance their original loan. Therefore, it has become highly urgent for these new types of credit products to be brought under the scope of regulation.

In addition to the risk posed by new and unregulated credit products specifically, lending malpractices or irresponsible lending of all credit products places borrowers at greater risk. As discussed in the previous section, poor creditworthiness assessments are a key irresponsible lending practice which is currently a huge problem. In addition, lenders often resort to poor and misleading advertising practices. The presentation of low interest rates is often prominently exhibited with exorbitantly high APR rates – averaging 2,543% for payday loans or 165% for revolving credit – often hidden in advertising.¹⁷ When consumers are not protected through regulation or lenders are not adequately supervised, the risk for over-indebtedness grows like a weed. While some argue that enhancing household financial literacy provides the solution, the impact of financial literacy programmes is very limited, with many programmes exhibiting limited or zero effect when targets are measured against valid comparison groups.¹⁸

Making sure that credit products (especially small value loans) are properly regulated to ensure they are not mis-sold to consumers who are unable to afford them, is the only effective way of directly managing over-indebtedness from use of credit at the source.

14 BEUC, “[The case for banning commissions in financial advice](#)”. 2019

15 Peter Norwood and Rita Antar. [Tackling causes of over-indebtedness in the EU consumer credit market](#). Finance Watch (March 2022).

16 [Factsheet – Creditworthiness assessment for small loans: the key to prevent consumer over-indebtedness](#). CCD Coalition (April 2022).

17 Norwood and Molinari. Consumer credit market malpractices uncovered.

18 Declan French and Donal McKillop. “Financial literacy and over-indebtedness in low-income households,” *International Review of Financial Analysis*, 48:1-11. (December 2016).

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About Finance Watch

Finance Watch is an independently funded public interest association dedicated to making finance work for the good of society. Its mission is to strengthen the voice of society in the reform of financial regulation by conducting advocacy and presenting public interest arguments to lawmakers and the public. Finance Watch's members include consumer groups, housing associations, trade unions, NGOs, financial experts, academics and other civil society groups that collectively represent a large number of European citizens. Finance Watch's founding principles state that finance is essential for society in bringing capital to productive use in a transparent and sustainable manner, but that the legitimate pursuit of private interests by the financial industry should not be conducted to the detriment of society. For further information, see www.finance-watch.org

Finance Watch
Rue Ducale 67 b3
1000 Bruxelles
T: + 32 (0)2 880 0430

www.finance-watch.org



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