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The Right Tool for the Job?

Mortgage Distress and Personal Insolvency during the European Debt Crisis

Wolfgang Bergthaler, Jose Garrido, and Anjum Rosha

WP/23/92

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2023
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IMF Working Paper
Legal Department

The Right Tool for the Job? Mortgage Distress and Personal Insolvency during the European Debt Crisis

Prepared by Wolfgang Bergthaler, Jose Garrido, and Anjum Rosha

Authorized for distribution by Yan Liu
May 2023

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ABSTRACT: The European debt crisis in the early to mid 2010s brought to the fore the issue of household debt distress: in the countries affected, widespread over-indebdtedness resulted in serious financial and social challenges. The crisis was primarily a mortgage debt crisis, but in several cases, the legal response was based on the introduction of personal insolvency procedures. This paper examines the challenges in designing and implementing legal reforms in this area to promote a better understanding of the main considerations in resolving personal insolvency and distressed mortgage debt in the context of crises. Lessons from the European crisis may prove valuable when dealing with the aftermath of the COVID-19 pandemic and the war in Ukraine on household debt distress.

JEL Classification Numbers:	K35; K25
Keywords:	consumer insolvency; household debt; mortgage debt; consumer debt
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* The authors would like to thank Jochen Andritzky, Nazim Belhocine, Leif Clark, Bruce Markell, Jason Kilbourne and Nadia Rendak for their very valuable inputs and comments; Salomee Bohbot, Min Ji Kim, Jesse Siminitz, and Aike Würdemann for their superb research assistance, and Sharon de Leon for her editorial and formatting work.

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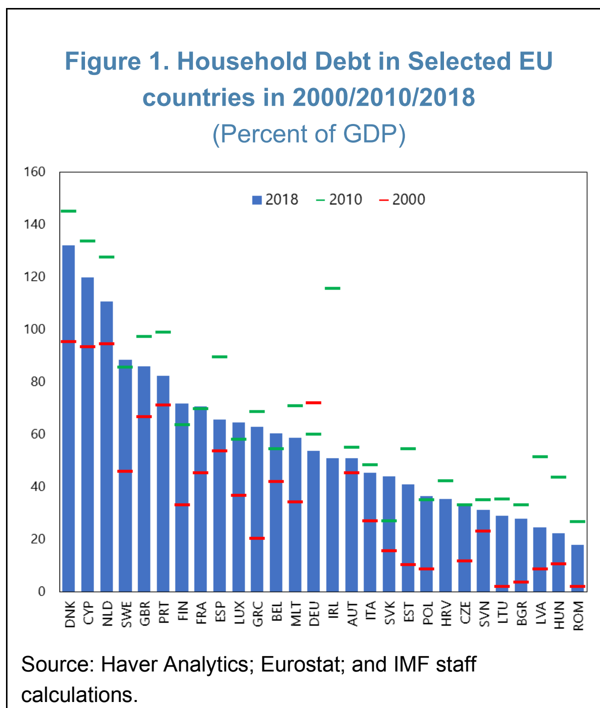
Introduction

1. **A novel feature of the European financial crisis was the widespread debt distress experienced by households.** In the years leading up to the crisis, household indebtedness (i.e., debts of individuals arising from noncommercial activities) increased in most European countries, as did the debt to financial buffers ratio of most households. (See Figure 1). The value of the underlying collateral that secured household debt (typically the debtor's primary residence) declined in many countries due to the economic downturn, and in some cases, exchange rate adjustments. The resulting non-performing loans (NPLs) became a drag on banks' balance sheets and, in some countries, were so high as to raise macroeconomic concerns.

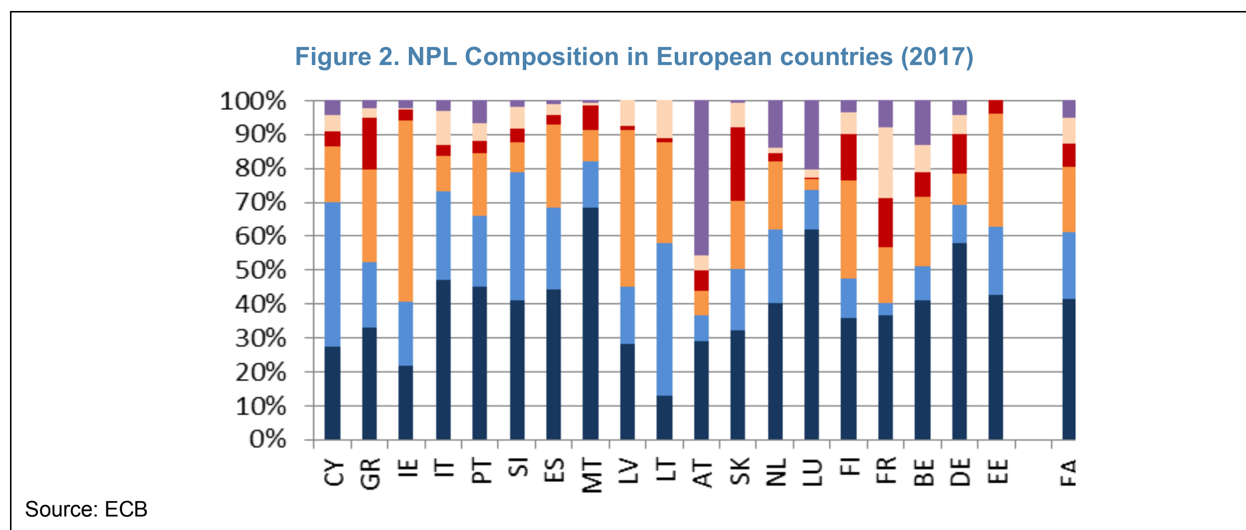
Figure 1. Household Debt in Selected EU countries in 2000/2010/2018
(Percent of GDP)



Source: Haver Analytics; Eurostat; and IMF staff calculations.

2. **A decade later, we know that from a macroeconomic perspective, the main source of household debt distress in the European crisis was mortgage debt.** Information collected by the ECB (see Figure 2 below, and Constancio, 2017) showed that the major source for distress in the crisis affected countries was the real estate sector, both in construction and real estate companies, and in households by way of residential mortgages. The significance of other sources of consumer debt was limited in most countries. Naturally, this points to the macro-economic importance of household debt. From the micro-economic perspective, consumer debt can result in severe economic consequences for thousands of households and individuals.

Figure 2. NPL Composition in European countries (2017)



Source: ECB

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3. **Addressing widespread household debt distress poses several challenges**. There are unique challenges in the legal treatment of household or consumer over-indebtedness:

- First, consumer insolvency is a relatively modern concept, directly correlated with extensive access to finance and use of consumer credit.[1] Unlike international best practices in enterprise insolvency (UNCITRAL, 2004; World Bank, 2016), there is only limited guidance in the area of consumer insolvency law (World Bank, 2013; INSOL 2001 and 2011; see Ramsay, 2017).

- Second, the insolvency of individuals raises economic considerations as well as additional concerns of a social and political nature.

- Third, household debt typically affects very large numbers of individuals owing relatively small amounts of debts. The potential high volume of insolvency cases can create critical issues of process and institutional capacity of the debt resolution framework (IMF, 2017b).

4. **There is now a significant body of country experience in establishing legal frameworks for resolving household debt distress.** Effective and efficient debt resolution regimes can play a critical role in the cost and availability of credit to households in the future, as well as in fostering growth through consumption and financial stability. For the continued availability of credit in the economy, maintaining credit discipline through an organized and transparent process of debt resolution that seeks to protect the rights of all parties and yield equitable and predictable results is necessary. While there is no standard approach, particularly for consumer insolvency, common tools that countries have used with varying degrees of success can be identified. The objective of this paper is to draw lessons from this experience and highlight some key legal aspects of consumer insolvency regimes and other techniques to address household debt distress.

5. **This paper attempts to contribute to a better understanding of the legal challenges surrounding household debt distress in a crisis context, in particular with regard to the use of personal insolvency law as a mortgage resolution tool.** Based on the crisis experience in Europe, the development of approaches to address household over-indebtedness raise multiple questions and complex issues.[2] Particularly, the use of personal insolvency laws to offer a degree of protection for the primary residences of overleveraged debtors has been a novel feature of legal reforms adopted during the European crisis. This paper discusses the need for a consumer insolvency regime and also includes a discussion of the problem of distressed mortgage debt. The analysis uses examples from selected European countries, especially those that had to implement reforms to address widespread household over-indebtedness.

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[1] Throughout this paper, the terms “consumer insolvency” and “personal insolvency” are used interchangeably. Personal insolvency is a broader concept that refers to the insolvency of natural persons (consumers or individual entrepreneurs) whereas consumer insolvency refers only to the insolvency of those natural persons who do not conduct an organized business activity.

[2] This paper discusses selected aspects of the law of certain European countries that were affected by the crisis, especially Cyprus, Greece, Iceland, Ireland, Latvia, Portugal, Romania, and Spain. It does not intend to provide a full overview of developments in Europe during the same period. The paper includes some references to other European countries (Austria, Croatia, France, Germany, Hungary, Italy, and the UK) and to the USA, solely for comparative purposes.

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Household Debt Distress in a Crisis Environment

6. **Household debt distress is an economic rather than a legal problem.** The concept describes a situation where households[3]-or consumers-experience difficulties in servicing their debt, and it encompasses a series of related concepts, such as over-indebtedness and insolvency. Over-indebtedness is a situation in which consumers are not able to meet their financial obligations in the near future. It is defined by an overall deterioration of their (and their dependents') economic situation which will gradually lead to social exclusion, higher cost of living ("the poor pay more") and less participation in overall economic development and social progress (Reifner et al., 2003). Insolvency is commonly defined as a state in which the individual can no longer pay his/her debts as they fall due. There has been an effort in Europe to map the elements of a definition of household over-indebtedness (EC, 2008), including, among them, the extent of the contracted financial commitments, the payment capacity of the household (over-indebtedness implies an inability to meet recurring expenses), the structural basis (a situation extended over time), the reference to the standard of living (the household must be unable to meet contracted commitments without reducing its minimum standard of living expenses), and the lack of liquidity (the household is unable to remedy the situation by recourse to sale of assets or credit).

7. **Widespread household debt distress may be one of the *consequences* of a crisis affecting the economy, but the latest crises have shown that extensive household debt can also become a *trigger* for a crisis.** Resolving systemic household debt distress requires a comprehensive strategy which should include reviewing the supervisory oversight of banks, prudential norms, legal and institutional frameworks for debt enforcement and insolvency, the market for distressed debt, and other supporting measures such as a communications strategy, improved information sharing, and debt counseling (Laeven and Laryea, 2009; Aiyar and others, 2015). An explicit or implicit role for the government may be a necessary part of the strategy. In the resolution of household debt, particularly mortgage debt distress (Box 1), the role of the government can vary greatly: it can establish the legal, regulatory and institutional framework that supports case-by-case workouts including by providing incentives and eliminating impediments to such workouts, and/or it can intervene more directly by establishing across the board debt relief programs, providing guarantees on account of or subsidies to debtors, or supporting the financial system by recapitalizing banks (Laeven and Laryea, 2009). In addition to broader reforms, interim measures may be required to complement the systems for debt resolution and to address the special needs and circumstances in a crisis. Such interim measures are typically temporary and designed to cover the crisis period without undermining conventional proceedings and systems (World Bank, 2013).

8. **Lessons from the European crisis may prove valuable when dealing with the economic impact of the COVID-19 pandemic and the war in Ukraine on household debt**. Before COVID-19 affected Europe and the world in 2020, the levels of household debt were high in most countries. The extensive fiscal and monetary support programs served to either reduce household debt distress or at least provide some measure of interim relief. Post-pandemic, and with the economic consequences of the war in Ukraine still unfolding, the situation may be reflective of increasing inequality: while a percentage of households will actually have reduced their debts and increased savings during the pandemic, a share of households will experience debt distress. For this

[3] Households are defined as small groups of persons (or one person) who share the same living accommodation, who pool some, or all, of their income and wealth. Household is a term frequently used in the economic and social sciences, but it has no legal equivalent. In the cases where a reference to a legal system is necessary, we use the term “consumer” or “individual”.

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reason, the importance of a proper personal insolvency framework and of appropriate mechanisms to address mortgage debt cannot be overstated.

Box 1. The Legal Response to Household Debt

There are three main elements in the legal response to household debt: (i) debt enforcement procedures; (ii) consumer insolvency; and (iii): institutions enforcing the law and providing support.

(i) **Debt enforcement procedures** (including foreclosure) represent the standard legal and are essential to preserve payment discipline. The law should provide for speedy and cost-effective ways of enforcing both unsecured and secured claims. For instance, in countries where foreclosure is lengthy and costly, secured creditors are likely to react to lower levels of recovery by restricting the availability of credit in the future, or by over-collateralizing their loans. Debt enforcement, however, also requires adequate safeguards to protect consumers against abuse, and a higher level of scrutiny over creditor actions.

(ii) **Consumer insolvency** addresses the problem of household over-indebtedness. It affords "honest but unfortunate" debtors a fresh start, while minimizing losses to creditors and maintaining credit discipline in the economy. The interests of creditors in recovering unpaid debts are balanced against the goal of maintaining honest debtors as productive members of society. Some of the main features of a consumer insolvency law may include the following (See Liu and Rosenberg, 2013):

- Allocate risks among parties in a fair and equitable manner.
- Provide a fresh start through discharge of financially responsible individuals from the liabilities promptly or after a period.
- Establish appropriate filing criteria to make insolvency procedures accessible to individual debtors through honesty and transparency so as to minimize abuse.
- Set repayment terms that accurately reflect the debtor's capacity to repay to ensure an effective fresh start.

(iii) The **institutions** that implement debt enforcement and consumer insolvency procedures are essential to an efficient legal response. The judiciary plays a central role, but in addition, consumer insolvency regimes rely on insolvency professionals, debt advisors and mediators and, in many cases, a dedicated administrative authority. There are other institutions that support the functioning of the regime: credit information systems; land and collateral registers; debt counseling services and legal aid clinics.

9. **Measures designed to deal with household debt distress during the crisis varied across Europe and were shaped by a number of factors:** the extent of household debt distress, the level of social protection available to distressed debtors, the health of the banking sector, the capacity of the relevant institutions (such as courts, mediators, and insolvency professionals) to handle a large volume of cases, as well as the political landscape in the country. A brief overview of such measures includes the following:

- *Consumer insolvency regimes.* During the crisis, Cyprus, Italy, and Spain adopted new consumer insolvency laws, and Greece and Ireland reformed their existing regimes. Many of the consumer insolvency reforms included fast track procedures, out-of-court debt restructuring mechanisms, and shorter discharge periods (Aiyar and others, 2016).

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- *Debt enforcement.* Portugal, Cyprus, and Greece also introduced reforms to address issues in debt enforcement and foreclosure (Pompe and Bergthaler, 2015; IMF, 2017a; IMF, 2017c; IMF 2018).

- *Institutional framework.* Many countries introduced additional training for judges (Portugal, Ireland, and Cyprus) and introduced or strengthened the insolvency practitioner profession (Cyprus, Greece, Ireland, Portugal). Spain and Greece relied predominantly on the judiciary, while in Cyprus, Portugal and Ireland, several features of the consumer insolvency framework were largely administrative (relying on insolvency professionals or mediators) and out-of-court.

- *Standardization.* Ireland, Cyprus, and Greece also adopted standardized and simplified forms to facilitate easier filings.

- *Support measures.* Other challenges addressed included information asymmetries such as limitations of real estate registries (Greece, Cyprus), and establishing debtor counseling and financial planning services (Ireland, Cyprus, Greece, and Portugal).

10. **Apart from legal and institutional reforms, direct government intervention took the form of interim measures designed to provide temporary relief during the crisis period.** Ireland, Iceland, Greece, Hungary, and Romania used ad hoc temporary measures that directly impacted the contractual relationship between the parties (for example moratoria on foreclosure on mortgages, or mandatory conversion of foreign currency mortgage loans into domestic currency at historic rates). Iceland provided temporary debt relief for "underwater" mortgages (i.e., mortgages in which the value of the real estate is less than the outstanding loan amount) and across the board mortgage reductions (IMF, 2012).

Table 1. Key Household Insolvency Legislative Reforms During the Eurozone Crisis in Select Countries

Cyprus	The Insolvency of Natural Persons (Personal Repayment Schemes and Debt Relief Order) Law (2015) introduced two procedures: (i) debt relief orders offering speedy debt relief for debtors with little income or assets from small unsecured debt of up to €25,000 and (ii) personal repayment plans providing debt restructuring for debtors with some capacity to repay, allowing the debtor to return to solvency within five years, while allowing the debtor to maintain a reasonable standard of living during the repayment period and, where possible, to keep his primary residence. The Bankruptcy law was also amended in 2015 to shorten the discharge period to three years.
Greece	Law 3869 of 2010 aimed at protecting primary residences of individuals (amended 2013 and 2015). In its original form the law provided blanket protection to borrowers against foreclosure of primary residences. In 2013, an amendment allowed for an extension of maturities for mortgages with minimum payments for four years for vulnerable debtors. The 2015 amendments introduced filters for strategic defaulters by dismissing incomplete filings (if not remedied within a deadline), provided for short deadlines for procedural steps such as hearings, limited the period of the stay of creditor actions, required minimum reasonable payments during the period of the stay consistent with the proposed payment plan, expanded the scope of the discharge to include tax and social security debts, and introduced a streamlined process for debtors with a limited amount of indebtedness and without mortgage debt. The 2015 reform also introduced stricter criteria for the protection of primary residences, and transitional provisions to migrate old cases to the revised regime within a short period of time.
Ireland	Personal Insolvency Act (2012, amended in 2015) introduced 3 procedures: (i) a Debt Relief Notice to allow for the discharge of relatively small amounts of unsecured debt, subject to conditions, up to €20,000 total for persons with essentially no income or assets, subject to a supervision period of three years; (ii) a Debt Settlement Arrangement for the settlement of unsecured debt (no monetary

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	debt limit to provide for maximum flexibility), normally over a five year period; and (iii) a Personal Insolvency Arrangement for the settlement of both secured debt up to €3 million (though this limit may be increased by agreement of the creditors) and unsecured debt (no limit), over a six-to-seven year period. The Bankruptcy Act of 1988 was amended to provide for automatic discharge from bankruptcy, subject to certain conditions, after three years, and permit court orders requiring payments from income for up to five years in the bankruptcy process. Further, a new Insolvency Service of Ireland to operate the proposed new non-judicial insolvency arrangements was established.
Italy	Law No. 3/2012, Decree Laws 179/2012 and 221/2012 established a new framework for personal over-indebtedness. The legal framework allows individual debtors to restructure their debt through a negotiated settlement process. Debtors can address their indebtedness problems either through an insolvency plan or through the liquidation of their estate.
Latvia	An over-indebtedness procedure was introduced in 2008. In 2010, a new insolvency law established a debt resolution framework for individuals. A court-supervised repayment plan was made available to individual debtors unable to reach a voluntary agreement with creditors. The process entails insolvency proceedings including liquidation of the nonexempt assets of a debtor, followed by an obligation settlement procedure which entails a court approved repayment plan. In 2015, amendments were introduced to fine-tune the law.
Portugal	The Code of Insolvency and Business Recovery provided two mechanisms to deal with the insolvency of individuals and small business owners: (i) the possibility of obtaining a discharge of residual debts if certain conditions are met, and (ii) the fast-track adoption of a payment plan.
Romania	A new personal insolvency law adopted in 2015 introduced procedures for adoption of a repayment plan and liquidation. It was designed as a largely administrative processes, with some court adjudication.
Spain	In 2013 the insolvency law was amended to introduce debt settlement agreements with the goal of promoting a “fresh start” for entrepreneurs, and also for consumers. A new law in 2015 (Law of Second Chance) extended the scope of discharge.

Overarching Legal and Policy Challenges

11. **The context of the crisis affecting households in European countries was different from the US mortgage crisis of 2008.** While consumer bankruptcy has been linked to the smaller role of the welfare state in the US (see Sullivan, Warren, and Westbrook, 2000), many European countries rely on public health systems and welfare benefits for the unemployed (see Ramsay, 2007), although the scope, volume and eligibility of public programs vary significantly across countries. The use of consumer credit in Europe has been traditionally less intensive than in the USA, although this trend has been changing in recent decades.

12. **Most of the European countries severely affected by the European crisis did not have a modern consumer insolvency regime.** Some had no regime for the insolvency of consumers (Italy, Latvia, Romania); in other cases, it was not adequate (Cyprus, Greece, Ireland, Portugal, Spain). As such, many European countries were missing an important tool to address household debt distress. Indeed, consumer insolvency is designed as the response to the situations created by the use of consumer debt, and the connection between the rise in consumer debt and the use of the bankruptcy system has been clearly established (Gross, 1999;

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Moss and Johnson, 1999; Ambrasaite and Norkus, 2014)[4]. The crisis resulted in governments taking fiscally contractionary measures which caused severe social and political tensions in many countries, complicating discussions on insolvency law.

13. **Overarching challenges to the reform efforts post-crisis included:** (i) the issue of burden-sharing between the public and private sector, (ii) in some countries, dealing with a large volume of cases, (iii) lack of precise data on the nature and sources of over-indebtedness, which limited the ability of the authorities to design accurate legal measures to address household debt distress; (iv) issues in the institutional framework and (v) fraud and moral hazard.

(i) Burden-Sharing between the Public and Private Sector

14. **Where extraordinary measures adopted by the state sought to override market solutions, the issue of burden sharing was relevant.** Resolving the debt overhang problem in a crisis requires the economy as a whole to bear a cost. The allocation of this cost between different stakeholders is a crucial issue (Laeven and Laryea, 2009). If direct government involvement determines the absorption of losses by the relevant parties, the levels of burden sharing between parties becomes a key policy choice (Laryea, 2010). The cost to the public sector is constrained by the available fiscal space. However, requiring the private sector to shoulder disproportionately high costs can contribute to bank failure and deepen the recession.

15. **Experience shows that policy approaches to burden sharing in Europe varied due to country circumstances.** For example, in Iceland, the burden of the across-the board debt reduction of mortgage principal equivalent to nearly 4.25 percent of GDP in 2014 that benefitted nearly 80 percent of households was absorbed by banks and their external creditors as well as the public housing fund(Andritzky, 2014). In Hungary, the state mandated conversion of foreign exchange mortgages to local currency at historical rates and banks were required to forgive 25 percent of the principal but could deduct some part of their losses from a bank levy. However, it was estimated that the schemes resulted in a net transfer of over 1.5 percent of GDP to households, of which two thirds was borne by the banks and one-third by the state (IMF, 2013b). In Greece, excessive state-mandated forbearance resulted in three rounds of bank recapitalization (IMF, 2017d). The bail-in in Cyprus impacted a large number of foreign depositors. As may be observed from these examples, in many cases where the cost to the private sector was high, it was not borne domestically. This could have a negative impact on foreign investment in these economies going forward.

(ii) Volume of Cases

16. **Countries with high volumes of insolvency cases considered ways to alleviate the pressure on the institutional framework**. As stated in paragraph 8, some countries adopted simplified procedures for consumer insolvency, and higher levels of standardization to address the increased caseload. For example, insolvency applications, along with the supporting documentation necessary to make a filing, were clearly

[4] For this reason, consumer insolvency covers a gap in traditional legal systems: "*All modern legal systems with advanced economies must address the question of how to respond to the needs of insolvent consumers whose burden of debt greatly exceeds their capacity to repay within a reasonable time frame*" (Ziegel, 2003; see also Anderson, 2004).

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specified (Ireland, Cyprus, and Romania). Clear guidance on exempt assets and on 'reasonable living expenses', as well as verified information about the debtor's assets and income can help with streamlining and standardizing the consumer insolvency process. In addition to making the process more efficient, such rules also bring a greater element of certainty and predictability to the insolvency procedure. An additional step that was considered was greater standardization of payment plans by creditors who would offer a set menu of payment options to debtors. The simplified insolvency procedure for no income, no asset cases (NINAs), which is described below (see Box 3), could also help ameliorate the pressure on institutions. In other cases, the institutional system suffered the pressure of a flood of consumer insolvency cases. This was the case in Greece, where the courts could not cope with the inflow of petitions. In theory, the hearing for the consumer insolvency case should happen six months from the application: in practice, the dates of the hearings were set for eight years later. In the period 2011-2016, only 5000 individuals had their debts reorganized, out of more than 100,000 petitions (Mentis and Pantazatou, 2015). The European countries included in this study did not consider the introduction of administrative bodies that could replace the courts in resolving personal insolvency cases.[5]

(iii) Lack of Data

17. **Lack of data on the sources and nature of household debt distress has been one of the major obstacles for the design and implementation of appropriate legislative responses.** While some countries, like France, have devoted significant resources to understand the causes of over-indebtedness (see Banque de France, 2014), in general, European countries faced the consequences of the crisis without detailed information on the number of households affected by over-indebtedness and the specific reasons for the over-indebtedness situations. The lack of adequate data resulted in multiple reforms that did not have the expected positive impact.

18. **The assessment of the performance of reforms also suffers from insufficient information.** Lack of data on the performance of consumer insolvency systems has been identified as a longstanding issue (Milman, 2005; Ramsay, 2012), and extends to the analysis of over-indebtedness. There have been serious efforts to increase the statistical information on personal insolvency proceedings (Ireland and Portugal are excellent examples), but basic information is missing in most countries. For instance, European countries do not produce reports informing on the number of persons who have obtained a discharge, which is the main objective and performance indicator for a consumer insolvency regime.

(iv) Issues in the Institutional Framework

19. **The limitations of existing institutional frameworks had to be considered in designing solutions for household over-indebtedness.** The institutional capacity in many countries affected by the crisis was limited, and there were scarce public funds to increase the resources allocated to the judiciary and supporting institutions. The focus in some countries was on strengthening the judiciary (Portugal, Greece). The development of the profession of insolvency practitioners was also an important objective for consumer insolvency regimes (Cyprus, Ireland). The quality of the institutions (courts, insolvency administrators) is

[5] One of the main reasons is that personal insolvency deals with sensitive legal issues, and the right to access to the courts, enshrined in the European Human Rights Convention, could pose a challenge in designing systems that restrict judicial remedies.

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particularly important for the effective operation of the insolvency framework.

20. **The complexity of household debt problems requires the support of auxiliary institutions.** Debt counseling, provided by public or non-profit institutions, performs an important function in the prevention and treatment of over-indebtedness. The consumer insolvency process needs to be affordable, and the debtor should have access to free or low-cost professional legal and financial planning assistance. Credit registers and public registries (real estate and collateral registries) provide basic infrastructure for the analysis of assets and liabilities of debtors, necessary for the preparation of adequate repayment plans.

(v) Concerns over Fraud and Moral Hazard

21. **While discharge for good faith debtors should be a feature of a modern consumer insolvency law, there is consensus that debtors who can afford to pay must not be incentivized to avoid payment**.[6] Modern consumer insolvency law is based on a shift from punishment of insolvent debtors towards rehabilitation and fresh start policies. A repressive insolvency framework has negative effects on consumption and entrepreneurship (IMF, 2012c; EC, 2003; 2011). A discharge of debts within a reasonable period of time does not necessarily give rise to moral hazard concerns and enables good faith debtors to return to productive economic activity. That said, the law should not shield debtors who have the means to pay but choose not to pay. The debtor's "ability to repay" is a difficult concept as creditors would like the debtor to pay the maximum amount possible but the debtor still needs funds for his/her reasonable minimum living expenses. To address this, several countries adopted detailed guidance on what constitutes 'reasonable living expenses' (Greece, Ireland, and Cyprus). Amounts in excess of reasonable living expenses are expected to be used to settle debts.

22. **"Strategic default" - voluntary default by debtors who can afford to pay but choose not to pay- illustrates the existence of a moral hazard problem.** Such default takes place when the gains from the default outweigh the perceived cost of presumed sanctions (IMF, 2017a). The debtor exploits the various inefficiencies of the system to avoid the consequences of default (e.g., design flaws in the law, no procedure for weeding out ineligible applicants to a relief measure, weak enforcement laws, delays and low capacity in the institutional framework, high volume of applications, or lack of information on the debtors' assets).

23. **It has been argued that moral hazard and fraud have been exaggerated as arguments against debtor-friendly bankruptcy reforms** (Kilborn, 2012, 2018). Although there is increasing evidence that these concerns may have been overstated in several countries, it should be noted that incidence of moral hazard and fraud varies from country to country and is difficult to study with precision. More empirical research on the topic is needed at the national level.

24. **Strategic default can be contagious and can negatively impact credit culture.**[7] Where ad hoc measures (such as blanket moratoria) are insufficiently tailored, or their enforcement is weak, maintaining credit discipline and limiting moral hazard becomes a critical challenge. While obtaining data on levels of strategic default is challenging, some studies suggest this was a significant problem in countries like Greece,

[6] "Discharge" of debt in insolvency implies that creditors can no longer take action against the debtor for the outstanding debt amounts. See Section IV. A. 4 below.

[7] Exposure to other people who have strategically defaulted and media stories about such defaults increase the propensity that other individuals will also default. See Guiso, Sapienza and Zingales, 2013.

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where extraordinary measures became the norm, severely damaging payment culture (IMF, 2017a).[8] Another case where strategic default became prominent was that of Romania: in 2016 a legal reform introduced, retroactively, the possibility of extinguishing mortgage debt by relinquishing ownership of the collateral (*datio in solutum*). Empirical analysis showed that the law increased strategic defaults (Andries et al., 2021).[9]

25. **Concerns relating to moral hazard applied to most reform measures, but they were heightened where extraordinary measures were used.** Most consumer insolvency law reforms are designed with sufficient safeguards so as to minimize moral hazard and consider economic considerations that balance the rights of debtors and their creditors (e.g., they apply to good faith debtors, provide for a time-bound stay on enforcement actions by creditors and liquidation of assets or repayment plans based on the debtor's capacity to repay). In contrast, extraordinary or *ad hoc* measures have tended to be over-inclusive and less well-regulated. Further, most consumer insolvency regimes are court-supervised, which introduces a fundamental set of checks and balances. Of course, in some cases, severe institutional failure resulted in backlogs of cases that made application of the legislatively provided safeguards impossible (Greece). In Cyprus, Ireland, and Portugal, the focus was rightly set on strengthening the institutions and building their capacity and resources to facilitate the effective implementation of the law.

26. **Most countries attempted to address moral hazard by restricting benefits to "good faith debtors."**[10] The insolvency process is based on a proper assessment of the debtor's capacity to repay (which means that the debtor must be insolvent) as well as on the examination of the cooperative behaviors exhibited by the debtor before, during and after the insolvency process, such as responding to notifications, sharing accurate and complete information about assets and liabilities in a timely manner, negotiating in good faith, and making agreed payments under a repayment plan per schedule (see for instance, rules adopted in Greece, Ireland, and Cyprus). The concept of "good faith" also takes into account whether the debtor has been involved in financial crimes or made repeated or overlapping filings or incurred debt with the purpose of filing for insolvency.

Selected Legal Issues

27. **While the crisis experience related to household debt in Europe has not been homogenous, a few features were common in several countries.** This section discusses technical issues in the design of consumer insolvency laws, with the main focus on the discharge of residual, unpaid debts, and the problem of

[8] A study using data from a large Greek bank concluded that 30% of the defaults on primary home mortgages appeared to be strategic (Artavanis and Spyridopoulos, 2017). The study also found that while less-privileged borrowers are more likely to default, they are less likely to be strategic with the opposite findings among higher income or better educated borrowers. The issue of strategic default of mortgages loans is debated among specialists: some studies conclude that during the mortgage crisis in the US, the levels of strategic default were substantial (Gerardi et al., 2018, estimate that 38 percent of defaults were strategic in the period 2009-2013). These levels of strategic default are normally attributed to the limited liability of mortgage debtors in most US states (see Balatti and Lopez-Quiles, 2021). However, revised methodologies have shown the number of strategic defaults in the US to be significantly smaller (Ganong and Noel, 2020, estimate that only 6 percent of defaults are purely strategic). The difference with the European cases is the role of the law: while the US studies focus on the behavior of debtors when mortgages are underwater, the European cases have shown the effects of moratoria, legal amendments and backlogs in the judicial system.

[9] The scope of the legal reform in Romania was restricted by a decision of the Constitutional Court adopted only a few months after the law entered into force. This reduced the incentives for strategic default (Andries et al, 2021).

[10] In most legal systems, if a debtor is found to not be acting in good faith, sanctions may apply which could include fines and penalties in addition to exclusion from discharge.

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the treatment of distressed residential mortgages. A deeper understanding of the specific over-indebtedness problems in crisis countries would offer interesting insights: as indicated before, the problems of mortgage debt distress were far more important in European countries than the over-indebtedness caused by consumer debt.[11] This is consistent with studies previous to the crisis that have established a relationship between the need of a fresh start policy in consumer insolvency with the expansion of consumer credit and the lack of a social safety net (Efrat, 2002 and 2006; Mann, 2006).

A. *Design of Consumer Insolvency Laws*

(i) Eligibility

28. **A consumer insolvency regime typically covers noncommercial debts of individuals.** These typically include mortgages, credit card debts, personal loans, and the like. The regime could also cover a limited segment of small entrepreneurs (as in Cyprus, Italy, and Greece). The question of whether owners of unincorporated small businesses should be covered under the consumer insolvency law or would be better served under the regime for business insolvency is a difficult one. Most enterprise insolvency regimes are relatively costly and complex, making it difficult for small entrepreneurs to access the proceedings and reducing the likely amount recoverable by creditors. However, the policy considerations in consumer insolvency are quite different from those in enterprise insolvency (e.g., considerations regarding repeated use). Enterprise insolvency regimes are necessary to handle the issues raised by individuals operating unincorporated businesses (such as obtaining working capital during restructuring, handling licenses and executory contracts, and aggregating competing creditor classes for negotiation and voting purposes).[12] From a policy perspective, the main concern is that there should be no gaps in coverage.

(ii) Access

29. **To access the consumer insolvency regime, the debtor must be insolvent.** There is no universal definition of insolvency for individuals, as a prerequisite for eligibility for relief. A common formulation of the test is the one found in enterprise insolvency law, according to which debtors must be “unable to pay debts as they fall due” and that such inability will continue for the foreseeable future. In personal insolvency, the over-indebtedness test is more closely related to the situation of the individual debtor and its household – there is over-indebtedness where there is a durable situation of difficulty to make payments as they mature while maintaining basic living standards. Other countries have used a qualified and complex standard, requiring that over-indebtedness is caused by reasons outside the control of the debtor (Cyprus), or requiring evidence of good faith (Greece, Cyprus). However, the trend is to refer to a general situation of insolvency or over-indebtedness, without further requirements. Complexity in the requirements for access is not recommended, as it can block access to deserving debtors. An approach that applies simple tests for eligibility and access, and then restricts the availability of discharge is to be preferred (McCormack et al., 2017).

(iii) Procedure

[11] See, for Latvia, Erbenova, Liu, and Saxegaard, 2011,

[12] There may be also cases where enterprise insolvency triggers personal insolvency, or vice versa.

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30. **European countries have designed different procedural frameworks for consumer insolvency, based on their own legal traditions.** The main objective of these procedures is to quickly assess the situation of the debtor, providing different alternatives for the exit from the insolvency process, at minimal cost. Numerous laws in Europe combine a liquidation of non-exempt assets with a repayment plan for a specified period. More complex systems include the possibility of retaining ownership of the primary residence by restructuring the mortgage loan (see Section I.B below).

31. **Although procedural frameworks vary greatly from one jurisdiction to another, some key features include the following:**

- *Stay of creditor actions.* A stay on creditor action at the outset is typical for all types of insolvency proceedings. During the insolvency process, a stay on creditor action protects the debtor by stopping any enforcement of debts and informal collection efforts. Stays could apply to all creditor actions (including pursuit of litigation), or might be limited; for instance, not all jurisdictions stay the enforcement of *secured* claims.

- *Majority voting and cram-down for the adoption of repayment plans*. In enterprise insolvency law, repayment plans are typically agreed by a majority of creditors by value. This is subject to certain safeguards (such as all creditors receiving at least as much as they would receive in a judicial liquidation—i.e., the 'best interest of creditors' test'—and approval/ratification of the plan by the court). If there are various creditor classes, majority voting may be implemented through a cram-down procedure. Such rules are designed to prevent holdout situations on the part of minorities and to prevent automatic vetoes by holdout classes. Consumer insolvency laws replicate the enterprise insolvency framework, but there is a trend to limit the decision power of creditors. In many personal insolvency cases, the repayment plan is unlikely to provide any meaningful payments to creditors, and its function is rather to subject debtors to a monitoring period to earn their discharge.

- *Disposable income and minimum standard of living for the design of repayment plans*. Under a repayment plan, for an agreed period, the debtor's disposable income is paid over to creditors in settlement of the debt owed, allowing the debtor to retain reasonable living expenses (which can be calculated using different methods, for instance, using levels of welfare assistance as a reference).[13]

- *Length of repayment plans.* The maximum length for repayment plans for individual entrepreneurs should be three years (Recommendation 2014/135; Directive 2019/1023)[14], but there can be variations in how the three-year period is calculated. Some European laws establish longer periods for the discharge of consumer debt. Modifications of repayment plans to respond to unanticipated changes to

[13] Typically, most legal systems give creditors and debtors a great degree of flexibility in designing restructuring plans. However, many countries also seek to protect some basic rights of the debtor for the public interest (which would also apply for liquidation): for instance, by permitting some of the debtor's assets to be excluded from attachment and sale to allow the debtor to continue to earn a living (such as professional books, tools of trade, reasonable mode of transport, i.e., "exempt assets"). For repayment plans, guidance on the minimum amount that the debtor requires to survive ("reasonable living expenses") which the debtor should be permitted to retain under a repayment plan is often established.

[14] Some countries (such as Czech Republic, Latvia, Romania, or Germany) link the discharge to paying a minimum percentage of the debt, and this also determines the length of the repayment period. Such requirements are arguably too inflexible and have in many cases been reduced or even eliminated (Austria). However, the possibility of linking the time for discharge to the payments to creditors is recognized for the insolvency of entrepreneurs under the EU Directive 2019/1023.

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the debtor's income or assets should generally be permitted.

(iv) Debt Discharge

32. **A discharge of unpaid residual debts at the conclusion of a consumer insolvency process provides individuals with a fresh start.** The fresh start policy represents an important social objective. Corporate entities, by virtue of their legal personality and limited liability for shareholders, in effect provide a discharge of unpaid debts to their owners in case of business failure. However, in the absence of special legal provisions providing a discharge of unpaid residual debts, no such relief is available to individuals (both entrepreneurs and consumers) for their debts. The conclusion of the legal process of personal insolvency should wipe out the residual, unpaid debts of a borrower, giving debt-burdened individuals the opportunity to start afresh (Kilborn, 2007). The fresh start policy has solid economic underpinnings, since discharge promotes entrepreneurship and results in renewed productive economic activity of discharged individuals (Jackson, 2005; Armour and Cumming, 2008). Without such a "fresh start," over-indebted individuals may continue to be pursued by creditors and may face major hurdles in becoming again productive members of society.

33. **Consumer insolvency laws in the countries studied now include a discharge, although an "earned discharge" is the norm** (see Box 2). Debtors have been discharged from their debts following relinquishment and liquidation of assets, satisfactory completion of a payment plan and fulfillment of certain conditions regarding the debtor's behavior. The discharge period has been at the center of many reforms in Europe, including in Ireland (Spooner, 2012), but also in other jurisdictions (Cyprus, Greece, and Latvia).[15] This is in contrast to the Anglo-Saxon jurisdictions which provide a discharge of debts upon conclusion of the bankruptcy procedure with full liquidation of the estate[16], without the requirement of completing a payment plan.

[15]Latvia has continued introducing reforms for discharge even after the period considered in this paper. On July 9, 2020, the Latvian Parliament approved amendments to the law that entitle credit institutions to unilaterally write off irrecoverable mortgage loans that had been taken before the economic crisis of 2008 in Latvia (in a situation when, since the crisis, many debtors had emigrated or have been otherwise unreachable or financially unable to cooperate, the bilateral agreement cannot often be achieved). The amendments apply to situations where the debtor has not been able to make the payment due to the economic crisis, the property has been sold in an auction, the outstanding amount has not been paid back to the bank for more than ten years. The amendment concerns only the unrecoverable mortgage loans issued exclusively in the run-up to the crisis. The procedure envisages that the personal income tax for the debtor is waived by the state, should the creditor legally waive the claims, and the loan is no longer on the balance sheet of the creditor. It is important to emphasize that the amendments do not impose the write-off as legal obligation, but only confer the right to the creditor to pass a unilateral decision.

[16] The discharge is available after a brief period of time during which interested creditors with full knowledge of the filing and the debtor's circumstances can raise an objection to the debtor's receiving a discharge, usually on grounds that the debtor's overall conduct has been fraudulent either shortly prior to or during the bankruptcy process. If no objections are raised during this time, then the debtor receives a discharge.

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Box 2. Relevance of the EU Directive on Restructuring and Insolvency for Consumer Insolvency

The Directive on Restructuring and Insolvency (Directive (EU) 2019/1023) includes the concept of a "fresh start" or "second chance" for insolvent entrepreneurs. The Directive includes multiple options for its implementation (see Garrido et al., 2021): EU members may make a full debt discharge contingent on partial repayment of debt, taking into account the individual situation of the entrepreneur. They may also require that the business or professional activity to which the debt is related has ceased. The maximum period for discharge is 3 years, and the Directive includes specific rules for the calculation of that period. The focus on entrepreneurs is consistent with the analysis conducted by the EC, which has emphasized the need to provide a "second chance" for entrepreneurs in Europe to encourage the private initiative (EC, 2003; 2011).

The Directive applies to entrepreneurs only. Nevertheless, the Directive emphasizes the difficulties in drawing clear lines between consumer and business debts in the case of entrepreneurs, and the need to address the problem of consumer debt. Thus, the recitals to the Directive allow and even recommend EU members to extend the application of the "second chance" regime to over-indebted consumers.

The Directive also provides some guiding principles which may be useful in consumer insolvency cases. First, it allows EU member to exclude certain debts from discharge (e.g., family maintenance obligations). Second, the Directive provides for the possibility of longer discharge periods when the main residence of the insolvent entrepreneur or his/her family is not realized or is safeguarded by a protective measure approved by a judicial or administrative authority. In these cases, the discharge period may be extended beyond the basically applicable maximum period of three years. In practice, rather than an extension of the discharge period, the Directive just addresses the fact that restructuring a mortgage loan will likely imply a longer repayment period than the three years envisioned for the discharge. The longer period, however, should only apply to the restructured mortgage loan, and not to the rest of liabilities.

(v) Debts that may be Discharged and Treatment of Secured Debt

34. **For effective rehabilitation of the debtor, discharge should be available for the widest possible range of debts.** That said, public policy also calls for certain exceptions to discharge (for example, maintenance obligations such as alimony and child support payments are frequently excluded from discharge[17] as are criminal sanctions and certain tort liabilities). A category of claims which have been typically exempt from discharge are tax and government claims. However, there is a notable trend away from this practice, particularly as these debts are often large and can undermine an effective "fresh start" for individuals. Ireland, following the example of other European countries, like Austria, France, Norway, and the UK, made tax debts dischargeable, but other countries avoided or restricted the dischargeability of tax claims, possibly concerned about undermining tax discipline (Spain).

35. **The intersection between personal insolvency and mortgage debt has been the critical point of contention in the design of reforms.** Many regimes preclude secured debt from being affected in the insolvency process without the secured creditor's consent. In addition, some European countries (such as the Netherlands or Finland) allow secured creditors to enforce the underlying collateral to recover their claims despite the insolvency process. However, in the countries analyzed in this paper, mortgage creditors are affected by the stay of creditor actions in insolvency, although modification of mortgage creditors' rights without their consent is only possible in some of them (Cyprus, Greece, and Ireland). In some countries, with regard to mortgages over the individual debtor's family home, there has been significant policy debate about the best

[17] Policy choices in insolvency generally concern the proper allocation of risks and loss-sharing, and most systems are unwilling to allow the debtors' responsibilities to their families to be avoided. While many non-business and even nonfinancial debts are included within the discharge for individuals, the focus of insolvency relief remains largely concentrated on debts created in the commercial marketplace, rather than within the intimate confines of the home and family relations (World Bank, 2013).

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approach for secured credit in insolvency (see section 4.B below on mortgages).

36. **Typically, an integral requirement for discharge is that the debtor has acted in "good faith."** While this requirement is couched in different ways, depending on the country's legal tradition, it ranges from ensuring that the debtor did not incur his or her debts with the purpose of filing for bankruptcy to different elements (such as absence of fraud), cooperation with the proceedings (good faith after the insolvency process starts). While this element is important in reducing the scope for fraudulent bankruptcies, it must be weighed against raising the bar for entry unnecessarily high for debtors whose creditors may challenge good faith at the detriment to debtors.

(vi) End of Process, Discharge, and other Considerations

37. **In most countries surveyed for this paper, at the end of the payment period, the debtor is automatically discharged without further court intervention.** This means that upon successful completion of the payment plan, the debtor would no longer be liable for any residual, unpaid debts, and creditors must write them off. In some jurisdictions (e.g., Romania), such discharge is not automatic and must be specifically requested by the debtor by an application to the court once the payment plan is successfully completed. The benefit of such enhanced judicial oversight should be weighed against the limited judicial resources and capacity. Of course, under both processes—but more so under the automatic discharge—the onus is on the creditors to act to prevent a discharge if the debtor has failed to perform under the repayment plan.

38. **The debtors' rehabilitation requires debtors not to be indefinitely excluded from credit markets.** Although a record should exist of the debtor's credit history, this should not overly restrict the debtor's rehabilitation. The debtor should be able to access financial services, including provision of credit on a reasonable basis. It is also important that the debtor is not discriminated against in obtaining housing and employment or establishing a business.

39. **The consumer insolvency regime should address the question of whether an individual can have access to the consumer insolvency mechanism more than once.** Unlike in business insolvency where there is a consensus that repeated business failure should not be penalized, many countries adopt a more limited approach in consumer insolvency. To prevent abuse of the consumer insolvency system, while still recognizing that some individuals may need to resort to bankruptcy more than once, some European countries include a time restriction so that an individual cannot access the consumer insolvency procedure again for a certain period (e.g., at least 10 years after discharge).

40. **The financial effects of the consumer insolvency reforms were limited in almost all cases.** Despite concerns about the use of consumer insolvency for fraudulent purposes, the limited evidence available suggests that the flow of consumer insolvency cases was limited in most countries (Cyprus, Ireland, Italy, and Spain). Greece was the major exception. Despite the limited data available, there is consensus that the number of consumer insolvency cases in the countries affected by the crisis was small, and the impact of consumer insolvency laws on the financial sector was minor, bearing in mind the low proportion of consumer debt within total problem loans, and the fact that unsecured consumer loans were fully provisioned.

41. **The social effects of the discharge policy are not adequately measured.** We only have data about the number of insolvency cases, which is a very imperfect metric and does not correspond to real discharge rates. Even so, just looking at the number of consumer insolvency cases, there are wide discrepancies between the

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number of cases in the more established European systems, with around 100,000 cases a year (England, Germany) or even 200,000 cases per year (France),[18] whereas in the countries affected by the crisis the numbers were very modest: around 1,000 cases per year in Spain (Rubio et al., 2017).[19] The exception, as indicated before, was Greece, were the consumer insolvency system became a mechanism to stay mortgage enforcement, rather than a true mechanism to provide a discharge to honest debtors. Greece had an extremely high number of consumer insolvency cases, but the number of discharged persons in Greece is unknown and could be very low, since debtors tend to remain within the process for years and a large percentage of cases are dismissed after prolonged delays. Unfortunately, statistics showing the number of discharged individuals are still rare. In Portugal, it is possible to extract those data from the Ministry of Justice's statistics, and in Ireland it is possible to infer a number of discharged individuals, although this requires careful analysis. In any event, these examples show a limited social effect of discharge policies, in terms of the number of individuals (see figs. 3 and 4).

Figure 3. Personal insolvency cases and discharges in Portugal 2012-2017

Year	Preliminary decision	Final decision
2012	3745	188
2013	7975	286
2014	7177	209
2015	7661	265
2016	8250	608
2017	9220	1607

Source: Ministry of Justice. The preliminary decision starts the period for the final granting of discharge, which comes with the final decision three years later.

Figure 4. Personal Insolvency Cases in Ireland 2014-2017

Year	Bankruptcy Adjudications	Arrangements (total)
2014	448	455
2015	479	1170
2016	526	1289
2017	473	1115

Source: Insolvency Service. Individuals are discharged three years after the bankruptcy adjudication. Arrangements include a variety of procedures that result in the full discharge with a 3-year surveillance period (DRNs), discharge of debt after 5 years (DSAs) and discharge of unsecured debt after 3 years, with restructuring of secured debt (PIAs).

[18] In all cases, these figures refer to the period considered for the analysis in this paper.

[19] Ideally, personal insolvency cases should be measured against the total population of the country (i.e., number of cases per 100,000), although this standard has not been implemented by most European countries. Using that metric, the results would show that England had 172 cases per 100,000 inhabitants; Germany, 121 cases per 100,000 inhabitants; France, 307 cases per 100,000 inhabitants; and Spain had 3'1 cases per 100,000 inhabitants (2017 data: the actual number of personal insolvencies in Spain in 2017 was 1492).

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(vii) Simplified Processes for Individuals with no Income and no Assets

42. **Following the precedent of other countries, Ireland and Cyprus introduced a simplified process for individuals with no assets and no income (NINAs) (see Box 3).** A large number of cases may remain unresolved because of the lack of means for the debtor to commence the insolvency procedure. Even if these cases were to go through the regular insolvency channels, they would tie up a disproportionate amount of institutional capacity and resources. This is clearly an exception to the concept of an "earned discharge," mainly on pragmatic grounds: the debtors benefiting from these special procedures do not have any substantial assets, do not have a regular source of income, and they only have *unsecured debts up to a limited amount*. The costs of the procedure are typically borne by the state (e.g., the cost of the application, and the provision of advice by professionals).

Box 3. Simplified Processes for No Income, No Asset Cases

Following the precedent of New Zealand and the UK, some European countries affected by the crisis introduced simplified procedures for debtor with no income and no assets. The goal of these procedures is to provide a simple solution to cases of consumer over-indebtedness without judicial intervention or reducing judicial intervention to a minimum. The fact that debtors have no income and no assets (so-called NINAs) eliminates the need for the elaboration of a repayment plan and also the liquidation tasks.

Ireland: In 2012, Ireland introduced the Debt Relief Notice (DRN) targeting debtors with virtually no income (less than €60 free disposable income) and no assets (less than €1000 personal assets), who owe unsecured debt of up to €35,000 (amounts as revised after the 2015 reform). The application is reviewed by the Insolvency Service, and the final decision is made by the court. After a debt relief order has been granted, the debtor's name is included in a registry, and the creditors may not pursue the debtor for any unpaid debts. The debtor is subject to a "supervision period" of 3 years, after which period, the debtor is discharged. If the debtor's circumstances change during this time and the debtor pays 50% of his/her debts, the supervision period terminates, and the debtor is immediately discharged. Since implementation, the total of DRNs processed in Ireland is just one thousand cases (data collected by the Irish Insolvency Service for the period 2015-2019).

Cyprus: In 2016, Cyprus introduced a system modeled after the Irish system. Debtors with less than €200 of disposable income, assets of no more than €1,000[20], and unsecured debts under €25,000 euros may apply for a Debt Relief Order (DRO). Applications are prepared with the assistance of an insolvency practitioner, reviewed by the Insolvency Service, and result in a court order granting the relief. Debtors are discharged after a one-year supervision period. There have been 613 confirmed DRN cases in Cyprus since the reform was adopted and until August 2019. The Insolvency Service of Cyprus projects that the number of DRO applications will remain low.

43. **The use of special procedures for consumers with no income and no assets requires certain preconditions**. First, establishing these procedures should be considered when there is a high number of individuals with no assets and no income. This is the most important prerequisite, because these procedures are designed with a certain type of debtor in mind: these procedures are not applicable to countries where debtors typically hold properties, for instance. The relevant thresholds for access to the procedure such as the amount of (typically unsecured) debt; amount of assets and amount of disposable income should be clearly stipulated, in line with economic circumstances.[21] There may also be disqualifications (for instance, having used the same procedure before, failure to provide accurate information or cooperate with creditors, having been convicted of financial crimes, etc.). Second, the system must provide safeguards against fraud. Typically, discharge takes place after a specified surveillance period, and the debtor is subject to monitoring and certain restrictions (e.g., a prohibition to incur substantial debts). Fraudulent conduct, either before the procedure, or

[20] These only include the personal assets. The Cypriot law also refers to the possibility of the debtor keeping a vehicle worth up to €4,000, and professional equipment for up to €6,000.

[21] These thresholds would vary based on local and national conditions.

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during the course of the procedure, should result in the cancellation of all benefits to the debtor. A different approach is the possibility of having “zero plans” under the regular insolvency procedure: in these cases, the debtor does not make any payments (as there is no repayment capacity) but continues to be subject to the restrictions of consumer insolvency until the discharge period concludes. Third, while the involvement of the courts may be necessary in certain legal systems, it is desirable to keep that intervention to a minimum and design the procedure to be largely administrative, supported by a robust insolvency profession. Finally, as with the regular insolvency procedure for payment plans, the procedure should provide for a situation where the debtor’s circumstances change (e.g., if the debtor finds new sources of income or acquires assets).

44. **The crisis offered an opportunity for the establishment and improvement of personal insolvency regimes in the affected countries.** Reforms introduced possibilities for the discharge of debts and a fresh start for over-indebted households. This has set foundations for the treatment of future situations of debt distress, but in the context of the European crisis, it appears that the reforms had a limited effect. The main reason is that personal insolvency regimes were deployed to fight mortgage debt distress, whereas the main use of personal insolvency regimes is the treatment of consumer debt.

B. *Mortgage Debt Distress*

(i) Background and Key Policy Considerations

45. **Several European countries suffered a deep crisis of their real estate markets**. In some cases, a real estate bubble was actually the trigger for the crisis (Spain, Ireland). In other cases, the crisis was exogenous to the real estate market, but had a deep impact on it (Greece, Cyprus). In the countries affected by the European crisis, household debt distress was mostly related to residential mortgages: for instance, in Portugal eighty percent of distressed consumer debt was related to mortgages, and as a practical observation, families tend to pay back mortgage loans even in the most difficult circumstances (Frade and Pinheiro Almeida, 2015).[22]

46. **In this context, residential mortgages—particularly mortgages over the family home—emerged as particularly thorny issue.** A mortgage loan has certain basic legal features (see Box 4). It is typically the debtor’s single largest debt and the underlying collateral (i.e., the debtor’s home) the debtor’s most valuable asset. In many countries, the crisis impacted a significant percentage of households causing them to fall behind on mortgage payments. As illustrated in Figure 2, the problem was particularly acute in Cyprus, Greece, Ireland , and Spain. In other European countries, despite the high levels of household leverage, NPLs in the household sector remained low (such as in Denmark, the Netherlands, and Norway).

47. **The laws applicable to mortgages vary across European countries, and harmonization has been limited.**[23] There are fundamental differences in all areas of mortgage law, but perhaps one of the most significant is the available procedures for enforcement and their relative efficiency in different countries. The existence of out-of-court procedures also affects the *ex-ante* behavior of credit institutions, as it has been

[22] During the US mortgage crisis, between 2008 and 2011, more than four million homeowners lost their homes to foreclosure, and there are many more homeowners who were forced to sell, often at prices that were less than what they owed on their mortgages (Joint Center for Housing Studies, 2013).

[23] The EU has adopted the Mortgage Credit Directive (Directive 2014/17/EU), which unfortunately arrived too late to make a difference in the immediate aftermath of the crisis (see Comparato, 2015).

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observed that quick and inexpensive enforcement reduces the loan origination standards (Feinstein, 2018).

Box 4. Selected Legal Features of Mortgages

Security Interest. A mortgage can be defined as a security interest in real property created by a debtor in favor of a creditor to secure performance under a loan. Mortgages need to be registered in a real estate registry to be fully effective. If the debtor fails to make the scheduled mortgage payments, the creditor may proceed to recover amounts owed through foreclosing on the property by arranging for its sale and applying the sales proceeds against the debt.[24] The procedural modalities for enforcement of mortgages are diverse: there are countries that allow out-of-court enforcement; other countries have designed a summary enforcement process, and finally, there are cases where mortgage enforcement is subject to ordinary civil procedure.

Liability of the mortgage debtor. Mortgages can be "full recourse": in that case, if the proceeds from the sale of the collateral are inadequate to satisfy the amount of the loan outstanding, the bank may pursue the debtor for the amount of the deficiency as an unsecured creditor. Therefore, in cases where the value of the property that serves as collateral declines and becomes less than the outstanding loan, the bank in effect has two claims – a secured claim for the amount of the loan up to the value of the property and an unsecured claim for the remainder of the loan (the deficiency). On the other hand, a mortgage can also be "non-recourse," and in that case, the bank may not pursue the debtor for the deficiency. Typically, mortgages in all European countries tend to be full recourse.

Priority status. All legal systems provide for a 'priority' or 'ranking' of claims when collateral is realized. The ranking of claims determines the order in which different categories of creditors are paid—typically, costs and expenses are paid first, followed by a ranking of creditors wherein a lower ranked category of creditors may only be paid after a higher ranked category of creditors has been satisfied in full.[25] Mortgages tend to provide creditors with full priority over the proceeds of the collateral. In some European countries (See Aiyar et al., 2016) there are examples of certain claims (tax, social security, or labor claims) taking priority over secured creditors. Since the rules for ranking of claims have a direct and substantive impact on the recovery of secured credit, if secured creditors are not ranked sufficiently high in the distribution, credit may be more expensive and scarcer, and the levels of collateralization required for lending might be expected to be higher over time.

48. **In most jurisdictions, secured creditor rights are safeguarded in an insolvency proceeding.** In the case of default under the mortgage contract, the creditor is entitled to enforce on the collateral, either separately or within the insolvency process itself. Protecting and prioritizing the rights of secured creditors in these circumstances is a policy decision that underscores the importance of secured credit in the economy and aims to protect the long-term availability of such credit at affordable rates.[26]

49. **Secured creditors are often permitted to enforce and liquidate their collateral in insolvency.** Many countries do provide for a short stay at the beginning of the insolvency process to allow for the possibility of an agreement on a repayment plan (e.g., Latvia, Ireland, Cyprus). As an alternative to liquidation of the collateral, secured creditors may agree to accept a repayment plan. If they do not agree, in a few countries (Cyprus,

[24] Mortgage creditors are typically banks, and therefore the terms "creditor" and "bank" are used interchangeably in this section.

[25] There are also rules of priority between secured creditors inter se. For example, the creditor who registers first ranks ahead of creditors with an unregistered mortgage or any mortgage that is registered subsequently. A subsequent mortgage can however rank *pari passu* or equally with a first mortgage with the consent of the creditor holding the first mortgage. Creditors can also reach subordination agreements, but their effects apply only to parties to the agreements.

[26] Secured credit mitigates the lender's risks in cases of default thereby increasing the flow of capital and facilitating financing. In the area of personal insolvency, there is a question regarding the application of *future income* toward the payment of claims. While the secured creditor has a preferential claim on proceeds from the sale of collateral, that creditor does *not* have any claim of priority on the *future income* of the debtor. Secured creditors have the right to demand that, if the debtor is going to *retain* the *use* of the creditor's collateral, the creditor is entitled to a level of repayment (funded of course by future income) sufficient to *adequately protect* its secured claim. In other words, the payment stream will at least equal the value of the secured claim (requiring a net present value calculation) and will not stretch over a period of time that will exceed the economic life of the underlying collateral.

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Ireland) a court may impose a repayment plan on unwilling secured creditors provided the plan meets certain minimum criteria.[27]

(ii) The Problem of Primary Residences in Household Insolvency

50. **In a crisis, there could be additional policy considerations that affect the treatment of residential mortgages, particularly over the debtor's family residence.** The main concern at times of crisis is that there will be widespread foreclosures with several negative consequences. The economic impact of a large number of foreclosures could weigh down the housing markets, depressing property prices further, lead to lower levels of consumption, and create a negative feedback loop through declining household net worth and housing investment, further exacerbating the crisis, and holding back economic recovery (Andritzky, 2014; Mian and Sufi, 2014). The displacement of a large number of debtors from their family homes could have serious social implications including increased homelessness and increased pressure on social security resources. Although there is consensus on the negative effects of mass foreclosures, there is considerable debate on the merits of the different approaches to prevent excessive use of foreclosure proceedings. The different approaches considered have included:

- Principal reductions of mortgage loans, to adjust to the depressed value of properties, either through the personal insolvency regime (judicial modification or cramdown of mortgages) or through government-sponsored mortgage modification programs
- Lender equity injections (bailout of the banking sector)
- Introducing a single seller that holds foreclosures off the market until demand rebounds.
- Slowing down the pace of foreclosures
- Acquisition of real state by the government

51. **Clearly both widespread foreclosures and excessive forbearance should be avoided, and each option has its own tradeoffs.** Economic analysis shows that policies that slow down the pace of foreclosures can be counterproductive, as they may lengthen the crisis. Government intervention has been defended as a method for rectifying the balance of supply and demand, but others argue interference with contractual relations should be minimized. Lender equity injections are effective, but that some mortgage modification programs may be less effective, because they may be imperfectly targeted, including borrowers who are not at risk of defaulting (Guren and McQuade, 2019). Regardless of the approach selected, it should be ensured that a clear strategy is in place as opposed to "kicking the can down the road", and that adequate implementation systems are put in place accounting for institutional capacity.

52. **In theory, judicial modification of the mortgage could be a feasible solution in a crisis context.** In the US, there were extensive discussions on the possibility of allowing cramdown of residential mortgages,

[27] As the secured creditor is typically the majority creditor in personal insolvency, the payment plan is unlikely to be approved without their consent. In some countries therefore, the court has the authority to impose a plan even on a majority creditor, but the plan typically has to meet stringent economic criteria to avoid excessive erosion of the secured creditor's rights.

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which is excluded under the US Bankruptcy Code.[28] Although that solution was widely supported by judges and academics (see Levitin, 2009), it failed to gain congressional support, and the US resolved its mortgage crisis without allowing the bankruptcy process to interfere with the rights of residential mortgage creditors.

53. **In addition, a large volume of mortgage foreclosures would test institutional capacity in a number of ways.** Where the foreclosure process relies on courts, the courts could become overburdened with applications, straining their ability to examine and review cases in a timely manner and serious case backlogs could develop. Similarly, the process of attachment and sale of collateral may require professionals who may not have either the resources or the capacity to deal with the large volume of cases, and property markets may not be liquid and deep enough to absorb the potential volume of sales. Informational gaps arising from the limitations of collateral registries may make the foreclosure process complicated and open to further legal challenges.

54. **Excessive forbearance also raises major policy issues.** In an environment where housing prices have declined, a majority of debtors have negative equity in their homes and the economy is contracting, foreclosures may not be practicable as there are no ready buyers. Moreover, policies that facilitate excessive forbearance by banks (i.e., a "wait and see" approach to enforcing collateral with no foreclosures, or virtually no foreclosures, in the hope that there is a recovery) could contribute to arrears accumulation, and if the slide in collateral values is not reflected in bank provisioning,[29] to under-capitalized banks. This could affect credit growth in recovery and cause banks to require high levels of collateral to extend mortgage credit in the future. In addition to creating financial uncertainty for distressed debtors who are already in default, excessive forbearance may also create the moral hazard of strategic default by debtors who can afford to pay but choose not to pay. Recent studies have shown that such moral hazard is contagious and can have severe detrimental effects on payment culture (IMF, 2017a).

55. **In response to the crisis, some countries took steps to "protect" the family home of at least a segment of insolvent debtors from foreclosure.** A range of strategies from largely government driven solutions, in agreement with the private sector (Iceland) to negotiated or market-based solutions (Ireland) were observed in response to the crisis. Even in the countries that took a firm stance on protecting the family home from foreclosure, only family homes below a certain value were sought to be protected—luxury family homes, commercial mortgages and investment properties were not. Moreover, most countries attempted to target protection measures at a small segment of "vulnerable debtors" —i.e., debtors from the economically weaker segment of society that were disproportionately affected by the crisis.

56. **The steps taken by certain European countries can be broadly classified into the following categories of measures**: (i) voluntary out-of-court techniques; (ii) changes to the insolvency and foreclosure

[28] The US Bankruptcy Code allows generally for the reduction of the value of the secured loan to the value of the collateral, with the consequence that the excess over such value becomes an unsecured claim. However, the Code expressly excludes residential mortgages from such treatment. During the US foreclosure crisis, there was an intense debate over the need to introduce an amendment that would allow the judicial modification (cram-down) of residential mortgages in bankruptcy (see White, 2008, Levitin, 2009; Scarberry, 2010; IMF, 2012; White and Reid, 2013)[28]. However, these amendments were not adopted, and the US resolved the foreclosure crisis without any bankruptcy reforms, although there is still an open debate on whether alternative sets of measures could have been more effective. White (2008) raised an important point: after the reforms of the Code in 2005, the decrease in bankruptcy cases meant that there was excess capacity in the bankruptcy courts, so they could have contributed to resolve insolvency cases involving residential mortgages. That institutional capacity was entirely absent in all the European cases considered in this paper.

[29] Bank supervision rules are outside the scope of this paper.

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laws; (iii) reforms to institutional framework; (iv) extraordinary measures; (v) mortgage modification programs; and (vi) social protection for the most vulnerable debtors.[30] Many of these were specific measures targeting mortgages over the family home, while others applied generally to all debt resolution tools but included such mortgages in the scope of their application. Most of these sought to find alternatives to foreclosures of the family home as the common view was that deferring enforcement of such collateral during a period of uncertainty about borrowers' finances and illiquidity in the housing market is desirable because it can act as a circuit breaker that limits the downward spiral (Andritzky, 2014) and in many countries, there were serious social and political pressures driving the process. Other measures sought to mitigate and address the social and economic fallout from foreclosures when they did take place.

(iii) Voluntary Out-of-Court Restructuring Mechanisms

57. **Voluntary out-of-court restructuring mechanisms can be a valuable complement to the formal insolvency law framework.** Out-of-court resolution implies market driven, case-by-case, customized solutions that are voluntarily agreed between the debtor and the creditor. Such procedures provide a speedy, flexible, low-cost alternative to court-supervised insolvency proceedings. Where debt distress is widespread, out-of-court procedures can help take the pressure off the institutions that are part of the formal insolvency and foreclosure frameworks to the extent excessive creditor leverage can be somewhat circumscribed.

58. **Countries promoted out-of-court debt restructuring through a combination of adopting guidelines/principles or encouraging banks to adopt a code of conduct.** Most of these procedures sought to enhance debtor protection and standardize bank procedures in arrears cases, in addition to providing a menu of options for debt restructuring such as interest only payments, maturity extensions, reduction of interest rate, write-offs, etc. They were designed to facilitate agreement on a repayment plan without resorting to the courts. For example: Iceland introduced temporary guidelines on voluntary debt restructuring for individuals, while Latvia established principles and guidelines for out-of-court consumer mortgage workouts to resolve mortgage arrears. Countries that adopted codes of conduct included Ireland, Cyprus, Greece.

59. **Some countries adopted special guidance for debt restructuring, targeting debtors who were considered economically vulnerable.** For instance, Portugal established an extraordinary regime for the protection of housing loan borrowers in economic difficulties, which provided a framework for voluntary workouts between banks and debtors who met certain vulnerability criteria in addition to the general regime for arrears settlement. Similarly, in Spain, the mortgage debt of debtors below a certain economic threshold could be restructured under the Code of Good Practices (Rubio et al., 2017). The special restructuring solutions –as in other European countries – failed to make an impact. For instance, and the result of the special Portuguese regime introduced in 2012 was that only 84 cases out of 1318 petitions were concluded (Frade and Pinheiro Almeida, 2015). The main reason seems to have been the difficulty in complying with all conditions for access to the procedure.

60. **A few countries espoused solutions which went beyond the typical menu of restructuring options.** For instance, in a few countries conversion of the full recourse mortgage into a nonrecourse mortgage for qualifying debtors at the option of the creditor was encouraged (e.g. in Portugal, the debtor could deliver the property to the credit institution or the real estate investment fund for a complete elimination of the debt

[30] This classification is largely conceptual as the same legal instrument could include measures that fell in more than one of these categories.

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provided at least the principal amount of the debt outstanding was covered by doing so) or such conversion at the option of the debtor (e.g. in Spain, after the debtor had been performing under a restructuring plan for a year). Debtors could also exchange their property for one of lower value that was owned by the bank or a third party, thereby reducing the principal amount of the mortgage (Portugal); or opt for a mortgage to rent conversion (Spain, and Ireland,).

61. **Mediation was used as a debt restructuring tool both out-of-court and often integrated into court supervised procedures.** Several countries introduced mediation to facilitate debt resolution out-of-court (Cyprus, Portugal, Ireland, and Iceland). In some cases, mediation was also a form of debt counseling (Portugal, Iceland) and in some countries the function was performed by the insolvency administrator (Ireland). Consistent with the French and German models, some countries introduced mandatory mediation as part of a court supervised process (Ireland, Cyprus, Spain, and Greece (2010)). In general, mandatory mediation may prove ill-suited to consumer insolvency as debtors seeking insolvency relief have little to offer their creditors and limited leverage (see Kilborn, 2016). Optional mediation, at the instance of the parties, may be preferable to avoid delay and expense.

(iv) Reforms of Consumer Insolvency Law

62. **A few countries incorporated special provisions related to treatment of residential mortgages into their consumer insolvency laws.** In most cases, for these provisions to apply, the debtor needed to be insolvent under the relevant legal system. These provisions affecting mortgages in insolvency involved case-by-case decisions but in many cases limited the rights of the creditors. The concern with such provisions is that they can be distortionary in the short term and may impact the availability and cost of mortgages in the medium to long term. These provisions seem to be aligned with the position that one of the goals of consumer insolvency should be the preservation of the family home.[31] However, this objective may be at odds with the objective of discharge and has serious implications for financial sector stability.

- ***Temporary reprieve for the debtor from the sale of the family home.*** For instance, in Latvia, the sale of a primary residence may be put off by up to one year; and in Cyprus, if the debtor's financial difficulties are as a result of the crisis, the debtor can request a suspension of enforcement or foreclosure for up to 6 months. As a temporary measure, Iceland's law allowed debtors, in certain circumstances, to remain in the residence for up to 12 months following the declaration of bankruptcy.[32] In several legal systems, the sale of family homes is subject to longer procedures and delays, irrespective of the existence of a crisis situation.

- ***Payment moratorium and mortgage loan reductions.*** For instance, in Italy, the debtor may propose a payment moratorium for up to one year; and in Greece (until 2015), if the debtor met certain criteria, the court could establish zero payment installments for non-secured creditors pending a final hearing and impose a repayment plan on the mortgage creditor that reduced the principal amount of the loan to 80 percent of the tax value of the property (without reference to the property's current market value or the debtor's capacity to pay).

[31] See EESC, 2014, referring to "keeping the main residence" as one of the main objectives that should characterize European consumer insolvency regimes.

[32] This temporary measure was available until 1 March 2010 (see Art 193 of the Insolvency Act, No. 21/1991).

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- ***Enhanced debtor rights following foreclosure.*** For instance, in Cyprus, the debtor has a preferential right to purchase the mortgaged property at a price equal to the highest bid at the foreclosure auction; and in Ireland, if the home was not sold within 3 years (typically because it continued to have negative equity), it could revert to the debtor subject to any mortgage, unless the debtor refused the option.

- ***Other additional protections.*** In Cyprus, the insolvency practitioner needs to consider whether the debtor wishes to retain the family home in formulating a repayment plan in Cyprus. In addition, properties of buyers who have paid at least 80 percent of the purchase price are shielded from foreclosure and banks are also prevented from foreclosing on the family home of a guarantor for the purpose of satisfying the liabilities of a primary debtor.

- **Some countries introduced compulsory restructuring of mortgage loans in consumer insolvency.** In Ireland, Cyprus, and Greece (2015), if the parties cannot agree on a repayment plan, the court may impose a restructuring plan under which a debtor is permitted to keep his or her family residence if that alternative is not economically less favorable to the secured creditor than selling the home. Effectively, this means that the debtor may keep his or her family residence provided s/he can pay at least as much under a repayment plan as the creditor would have recovered in liquidation. In the countries that adopted this rule, it applies only where the market value of a family home is lower than a ceiling prescribed in the law and the debtor meets certain eligibility criteria. The main considerations are:

- ***The mortgage creditor is concerned with maximizing recovery.*** The liquidation value of the home provides a good indication of what the creditor is likely to recover as a secured creditor. The remainder owed to the creditor becomes an unsecured claim. Of course, most insolvent debtors would not have any other significant assets that the creditor could pursue to recover the deficiency, so the recovery rate on the unsecured portion of the claim is likely to be extremely low. The court-imposed restructuring plan would reflect the economic reality of the secured and unsecured portions of the creditor's debt.

- ***Debtors with negative equity need to be incentivized to cooperate.*** Debtors who continue to have some equity in their homes have a clear incentive to cooperate with the creditors to arrive at a voluntary, negotiated payment plan. Debtors whose equity has been wiped out or those who have negative equity in their homes may not have a clear economic benefit in cooperating with their creditors in the absence of some reduction in the principal amount of the debt. Of course, a widely held view is that the family home is worth more to the debtor than the market value of property (particularly, in a depressed real estate market) and therefore, in some countries, such as Iceland, the agreement between the government and creditors included the measure according to which consumers would pay 110 percent of the liquidation value of the house to preserve its property.

- ***Capacity to repay is taken into account.*** The court-imposed repayment plan will require debtors desirous of keeping the family home to have the capacity to pay the *minimum* of the liquidation value of the home. This implies that the capacity of the debtor to repay would be a factor taken into account in designing the court-imposed payment plan. And on the other hand, debtors who cannot repay the minimum of the liquidation value of their family home would not be protected from foreclosure.

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- ***Eligibility criteria are restrictive.*** Typically, only vulnerable debtors with low-value primary residences are eligible.

- ***In some cases, the law permits the creditors to share in the upside.*** In the event that the property markets recover, and the debtor sells the property for a price greater than the liquidation value under the repayment plan, creditors may be permitted to share in the "profit" to the debtor (claw-back). Through the claw-back process, creditors may regain the right to collect all or part of a previously written off part of the claim.

63. **Compulsory mortgage restructuring within consumer insolvency laws has limitations**. The experience in the European countries affected by the European crisis offers some lessons:

- In the absence of a capable and well-resourced court system, compulsory mortgage restructuring as a component of consumer insolvency results in procedural complexity and could give rise to massive case backlogs (Greece).

- Valuation issues have proven to be extremely difficult to resolve in the context of insolvency proceedings. The fact that the affected countries suffered shocks that threatened economic stability and the entire real estate market made the valuation of collateral particularly challenging.

- Banks do not have incentives to restructure mortgages when this results in losses to their balance sheets, so they delay and resist the restructuring within the consumer insolvency process (Ireland, Cyprus). The result is delay in the resolution of mortgage NPLs. In the case of Cyprus, there were only 53 cases of confirmed non-consensual personal insolvency arrangements (PIAs) for the period June 2017-August 2019. In Ireland, the Insolvency Service offers limited statistical data on non-consensual PIAs, but the 2017 annual review showed that, after adoption in late 2015, there had been 203 decisions on compulsory plans in 2017– and only in 65 of these cases the plan was approved despite the opposition of the creditor (in addition, 6 of those cases were appealed by creditors) (see also Kelly et al., 2021).

64. **Thus, the introduction of compulsory modification of mortgages in some European countries has not delivered the expected results.** The reduction of NPLs in the residential mortgage sector has been much slower in the countries that adopted these provisions (Cyprus, Greece, and Ireland) than in countries that combined foreclosures with informal restructurings (Portugal and Spain).

65. **The threshold question thus remains whether mortgage debt should be resolved through a consumer insolvency procedure.** In the largest European economies (France, Germany, and UK), mortgage debt is excluded from consumer insolvency procedures which deal mainly with unsecured debt and aim to provide a discharge. When mortgage restructuring is included within consumer insolvency, protection of the home may occur at the expense of a speedy discharge. In Greece, the repayment plans for the mortgages were extended for such long periods that the authorities were eventually discussing the need to allow the *inheritance* of repayment plans. This evidences a collision between a fresh start policy and the policy of maintaining ownership of the home, but there is also a collision between maintaining ownership of the home and financial stability – as these procedures drag on and prevent banks from taking other actions to resolve NPLs. In the end, these insolvency procedures integrating mortgage restructuring do not appear to have provided a fresh start to debtors and have not significantly contributed to financial stability either. Mortgage

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debt is a bilateral relationship – if debtors experience problems in repaying their mortgage loans, this should be resolved at a bilateral level. Insolvency is a collective process for the resolution of multiple debts, and it also attaches stigma to the person using the process (see McCormack, 2016). Using the insolvency process to impose losses on banks will be resisted and contested, and banks may use all the available procedural means for litigation. The strategy of using judicial modification of mortgages could have succeeded in the US, because of the existence of a strong personal bankruptcy regime and experienced courts and institutions. However, assigning these extremely complex tasks to newborn legal regimes and inexperienced judges and insolvency administrators proved to be too demanding.

(v) Reforms to Foreclosure Laws

66. **Reforms to foreclosure laws were also undertaken in a number of countries.** Some of these revisions addressed delays and inefficiencies in procedures (sale price, type of auction, and procedure in case of failed auctions) and generally required reforms of Civil Procedure (Ireland, Greece, Cyprus, Portugal, Italy, and Spain). E-auction systems were introduced in several countries (Spain, Italy, Greece, Latvia, and Cyprus, among others).[33]

67. **The design of foreclosure proceedings raised complex social and political questions.** A focus on the efficiency of foreclosure proceedings was perceived in some countries as providing an advantage to financial institutions, to the detriment of distressed debtors. Although several countries needed to streamline procedures to reduce the times for enforcement of mortgages, in a particular case (Spain), the intervention of the ECJ demanded that the legislator introduce reforms to provide for a more intensive protection of the interests of financial consumers.[34]

(vi) Extraordinary Measures

68. **Given the widespread nature of the problem, some countries introduced extraordinary measures that did not rely on negotiated or market-based solutions.** Some of these required difficult trade-offs and raised moral hazard concerns (see Box 5). Most extraordinary measures were temporary, focused on vulnerable debtors and overrode the contractual terms agreed between the parties. Many did not require the debtor to be “insolvent” as defined by the national laws of the country. These measures were generally limited in scope and time because of the potential impact of these measures on financial institutions. They varied from requiring court intervention to measures that were largely administrative in nature.

69. **Direct government intervention took a few different forms.** For instance, Iceland introduced across-the-board mortgage principal reductions: one program encouraged creditors to make time-bound offers to debtors write down qualifying mortgages to 110% of collateral value in cases where the debtors were deeply underwater; a second and later program provided a 13% write down of inflation indexed mortgages financed by a bank levy, mainly borne by foreign creditors of the failed banks’ estates, and an offer for a tax free reallocation of voluntary pension contribution towards mortgage repayments (Andritzky, 2014). Some countries

[33] In addition to improvements to the procedural framework for enforcement, Greece also reformed the rules relating to the ranking of claims. In particular, limiting or reducing the priority of payment for public creditors was a significant policy discussion in Greece, since the prevalence of public interests over secured creditors was perceived as an obstacle for restructuring and enforcement of mortgages.

[34] See *Aziz v Caixa d'Estalvis de Catalunya* (2013) Case C-415/11.

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limited the rate of penalty interest that could be charged by creditors (e.g., Spain, Cyprus), or froze all repayments for a time (Iceland). Others adopted measures such as moratorium on enforcement or on evictions, conversion of foreign exchange loans into local currency at historical rates, conversion of mortgages to non-recourse.

70. **Many extraordinary measures aimed to protect the most vulnerable segments of society but were not adequately targeted and/or were poorly implemented.** While many extraordinary measures included eligibility criteria (e.g., maximum value of family home sought to be protected, income requirements, family size, limits on other property owned, among others) and required debtors to go through an application process, in many cases the criteria were over-inclusive, with high attendant costs. For example, in Greece, the moratorium was designed to apply to individuals whose homes did not exceed a certain value; however, this value was based on the tax value of the home which was largely historical at the time and most homes fell within the defined perimeter. Similarly, the programs for conversion of foreign exchange loans into local currency at historical rates (Romania, and also in other countries such as Croatia, Hungary, and Poland) were designed with overly generous eligibility criteria with insufficient burden-sharing of consequent losses between the state and the banks

71. **If not fiscally funded, the impact of extraordinary measures on private creditors should be carefully considered before their introduction.** Interference in the market mechanism necessarily causes distortions and is often associated with additional budgetary outlays. While temporary in nature, these measures have proven costly and administratively burdensome. Most importantly, the implied interference with private contracts undermines credit discipline and could potentially hurt future investment (Liu and Rosenberg, 2013).

Box 5. Examples of Extraordinary Measures

Moratorium on foreclosure of residential mortgages over the family home (Iceland, Ireland, and Greece). A moratorium is a suspension of foreclosure and is a form of extreme forbearance. It took several forms – formal (Greece 2010, Ireland, Iceland) or informal (Cyprus, Greece 2014), blanket moratorium (Iceland, Greece 2014) or a targeted moratorium (e.g., applicable to low-value family homes of low-income households) (Ireland, Greece 2010); automatic (Iceland) or application based (Greece). A variant of the moratorium on foreclosure was used in Spain where a special law permitted vulnerable mortgage debtors to remain in their homes for two years following foreclosure, provided they could pay a minimal rent. The main drawback of moratoria is that they do not address the underlying debt problems and, if not part of a comprehensive strategy for crisis resolution, can create uncertainty and lead to widespread strategic default.

Conversion of forex denominated mortgages at historical rates by operation of law. In some countries where exchange rates moved unfavorably against debtors whose mortgages were denominated in a foreign currency, the loan was converted into local currency at historical rates by operation of law (Romania, as well as Croatia, Hungary, and Poland). Such retroactive modification of contractual terms by statute resulted in substantial losses for banks in countries where such lending was widespread and was the subject of constitutional debate on grounds of whether it could be considered expropriation by the state.

Conversion of existing mortgages to non-recourse. Delivery of the real estate collateral in exchange for the extinction of the loan (*datio in solutum*) is generally recognized as a solution agreed by debtors and creditors, but not as a mandatory solution. However, Romania adopted a law that permitted debtors to discharge their existing loans in entirety through the transfer of the collateral to the creditors (see Macovei, 2019). If the proceeds from the sale of the collateral were inadequate to satisfy the amount of the loan outstanding, contrary to general mortgage principles, the creditor would not have any further recourse against the debtor. This measure was considered problematic as it served to transfer the downside risk of real estate ownership to the banks and could leave banks holding property for long periods if the housing market did not recover. The Constitutional Court set more stringent

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conditions for the use of this option, which resulted in a reduced use of the measure by debtors.

(vii) Other Social Protection Measures

72. **Given the magnitude of the crisis, and to mitigate its economic impact, a few countries enhanced social protection measures that were funded from the fiscal envelope.** Examples of these include rent benefits provided to those who are evicted (Spain); a mortgage interest supplement scheme (Ireland); and a mortgage payment subsidy scheme covering a percentage of loan payments (Cyprus, Greece). Free or subsidized legal aid services for low-income debtors facing foreclosure were also introduced (Ireland, Cyprus). Although state-supported mortgage modification has emerged as one of the tools to resolve a crisis in the residential market[35], its use was limited in Europe due to the lack of fiscal space and competition law concerns.

Conclusions and Main Lessons for the Way Forward

73. **Legal and institutional reforms were considered an important tool in addressing household over-indebtedness during the European Crisis.** Most European countries affected by the crisis now have modern consumer insolvency laws, and several countries also improved debt enforcement procedures including those for foreclosure. The affected countries sought to develop more robust insolvency institutions. These reforms were an important component of the broader crisis resolution strategy. Of course, while legislative measures can be quickly adopted, implementation takes time and thus, legal and institutional reforms may not bear immediate fruit.

74. **There is now broad consensus in Europe that personal insolvency law should include provisions for discharge of the debtor from any unpaid liabilities after a short (maximum three-year) repayment period.** As the purpose of the discharge is to give the individual a fresh start, all disclosed debts should be dischargeable with narrow exceptions for public policy reasons (e.g., child support, some tort liabilities, criminal fines, and penalties). The system should provide for safeguards to ensure that debtors are acting in good faith by requiring debtors to cooperate fully with their creditors and make complete disclosures which should be updated as needed. Asset-less debtors should not be excluded from the system - a special, simplified procedure could be considered for these cases. Personal insolvency remains the primary tool to address the problems of excessive consumer debt.

75. There remain additional areas where many European countries could strengthen their personal insolvency frameworks:

- *Further simplify and standardize procedures.* Even though the volume of consumer insolvency cases may be high, the nature of the cases is typically quite straightforward. There are limited assets, and the main liabilities are normally vis-a-vis one bank. Standardization increases both efficiency (time and cost) and ease of use for the consumer. Increased standardization of application forms and disclosure

[35] The US used a mortgage modification program (HAMP) and a mortgage refinance program (HARP). These programs were used to modify the terms of mortgages, providing limited relief to debtors.

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schedules should be considered.

- *Out-of-court options for debt resolution should be developed further and promoted*. Out-of-court debt resolution options are cheaper, faster, and more efficient. These options also include procedures run by administrative authorities, rather than courts. When coupled with independent debtor counseling on financial matters, such solutions could prove a valuable complement to the formal insolvency framework. It is recognized that out-of-court solutions work best when the formal system functions well and offers predictable results.

- *Debt counseling services and legal aid should be available*. Individuals need access to free or inexpensive debt counseling to successfully navigate through the insolvency system and avoid over-indebtedness in the future. Such debt counseling could be part of legal aid clinics or provided independently. The use of technology (apps that track spending and design budgets) could be particularly helpful in this regard.

- *Robust data collection*. The impact of reforms can be best understood through detailed data collection about the different aspects of the system. Data collection and analysis can also help inform future evolution of the consumer insolvency system (Garrido and others, 2019).

76. **The European crisis highlighted certain key factors that should be considered in the design of legal reforms.** Reforms should be part of a clear overarching strategy and should seek to establish rules that minimize strategic default and abuse of the system while facilitating resolution for good faith debtors. In times of crisis, government intervention may be necessary. As far as possible, such intervention should allow contractual terms to be respected and for participation in any schemes varying contractual terms to be voluntary for the parties. If the government takes actions that directly affect contractual relationships, such interventions should be carefully designed with a view to addressing the underlying problem (i.e., turn troubled loans into performing loans), be selective and target borrowers whose ability to restructure debt is likely to be restored through the measure, and be simple and transparent. In the design of a strategy, the burden-sharing between the private and public sector also needs to be considered, taking into account the fiscal envelope and long-term impact of the measures on future credit in the economy as well as on the financial sector. Finally, institutional capacity should be a key consideration in designing reforms. The volume of cases may be high and solutions that ensure that the institutional framework does not become a bottleneck should be given priority.

77. **Given that the crisis in many European countries was one of mortgage defaults, the reliance on consumer insolvency law as a resolution tool was possibly misplaced.** The crisis in European countries affected the financial sector through the increase of non-performing loans particularly mortgages. Where personal insolvency was used to resolve mortgage loans, the results were not optimal. This is because personal insolvency plays a fundamental role in addressing over-indebtedness of individuals, by providing those individuals with a fresh start and as such, is best suited to deal with unsecured debts. Mortgage loans are traditionally dealt with outside of insolvency procedures, through an efficient enforcement mechanism.

78. **The resolution of mortgage loans in the context of crisis deserves special consideration.** Alternatives to compulsory restructuring of mortgage loans over primary residences should be explored. The disadvantages of using insolvency for the restructuring of mortgage debt is that it attaches stigma, creates a litigious environment, may be contested by banks, and may delay the resolution of NPLs for lack of institutional capacity. To the extent possible, the country's social safety net and/or social measures (and not the insolvency

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law) should be used to safeguard the interests of the most vulnerable members of society. This point is valid for the role of personal insolvency laws in general, and it is especially relevant for the treatment of secured credit. It is recommended that secured credit should generally remain outside the purview of consumer insolvency (see IMF, 2019). Any special provisions must be weighed against the economic impact of the measure on credit availability going forward.

79. **The experience through the European crisis also offers some insights and lessons for the future.** In contrast with the austerity response to the previous crisis, countries are using fiscal buffers to provide extensive fiscal and monetary support in an attempt to shore-up households and businesses from the consequences of the pandemic and the war in Ukraine. As these interim measures wind down, some countries may experience wide-scale household debt distress for which their existing insolvency and debt resolution frameworks may not prove adequate. Reforms to personal insolvency to allow good faith debtors a fresh start, strengthening institutional structures to enhance capacity, and special measures (ideally social protection programs) that are targeted at the most vulnerable to offer temporary backstops may be necessary. Designing separate legal mechanisms to address excessive mortgage debt is also necessary. The lessons from Europe could help inform, design and sequence legal reforms in the post-Covid 19 pandemic and post-war recovery.

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