IN FOCUS

Relief Policies for Over-Indebted Households and Small Businesses

The Covid-19 pandemic has prompted a social and economic crisis that has exacerbated existing structural weaknesses in retail finance and left households increasingly vulnerable to financial distress. This is due to a global system where some financial regulations rule over real economy and people, instead of serving them. Shifting this paradigm will require developing appropriate public policies and reforms to ensure that the current system can work for everyone.

Working Group 2

Situation, Analysis and Proposals
Ecology | Economics | Health | Security

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The Situation

Covid-19 has exacerbated previous crises, including the rise of household debt

The Covid-19 pandemic prompted an abrupt increase in the unemployment rate worldwide, as countries put in place mandatory business restrictions, quarantines and other containment measures.

While an economic rebound is likely if Covid-19 is brought under control, the pandemic will still have long lasting consequences on the workers that have already been made redundant and on those who will lose their jobs in the coming months due to the default of their employers.

For lower and middle income families living in industrialized countries, unemployment can immediately trigger financial distress, due to high levels of household debt. Moreover, in a substantial number of cases, the loan origination process doesn't take into adequate consideration the overall financial situation of the borrower and the borrower's ability to sustain the debt.

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Even before the Covid-19 pandemic, households were already experiencing difficulties. In 2016, nearly 14% of people in the European Union reported that their household was in arrears and unable to pay rent or mortgages, credit card bills, loans from family or friends, or utility or telephone bills. While 25–49-year-olds were most at risk, over-indebted people aged 65 and older experienced greater financial problems and lower mental wellbeing than the other groups. Single parents were also struggling. From 2017 to 2018, arrears among single parents at risk of poverty increased across the European Union (EU). Many countries have complex webs of support and legislation that are hard to understand and many over-indebted people do not get suitable help or fail to access appropriate debt settlement procedures.

The consequences can be catastrophic. A borrower's default on his or her mortgage can result in foreclosure and asset seizure, putting all family members at risk of losing their home.

Beyond the fact that banks can exploit the debtor's situation by applying additional fees and higher interest rates, current global financial regulations require banks to comply with very strict regulatory standards in dealing with 'non-performing loans' (NPLs) – loans subject to late repayment or unlikely to be repaid. There is therefore, a strong counterincentive to adopt any initiative (e.g., arrears waivers, moratoria, etc.) that is intended to alleviate the debtor's situation. It is expected that NPLs will rise sharply once measures put in place to support households and businesses during the pandemic, come to an end.

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Analysis

A preferential option for the poor implies an economy not ruled, but *served* by finance

The current global regulatory framework (as set out by the Financial Stability Board and the Basel Committee) approaches the issue of non-performing loans from the sole perspective of financial stability. The goal is to avoid excessive losses on banks and does not address the problem from the debtor's perspective and his or her need of protection. (EU financial regulators assess risks to the financial sector after the outbreak of COVID-19 and call for enhanced cooperation).

In December 2020, the European Commission unveiled an Action Plan to tackle NPLs. The Action Plan aims to address the likely accumulation of NPLs in the EU, including by calling on the European Parliament to quickly agree on EU rules, proposed in 2018, to create a single secondary market for the sale of NPLs.

Financial stability alone, however, cannot safeguard against social exclusion. In the long run, this approach would itself be in contrast with the purpose of protecting financial stability, insofar social exclusion of a large number of households would harm the global economy as a whole and, subsequently, financial stability.

For example, in order to comply with regulatory and supervisory expectations, defaulted loans are often bundled and sold to securitisation special purpose vehicles (SPVs) that are funded through leveraged finance whose approach to the debtor is even more aggressive than the originating bank's approach, thereby increasing the risk of excluding a high number of households, especially those belonging to the most disadvantaged and most vulnerable social groups.

> ***There is a need to develop a social sustainability model that can mitigate default risk***

During times like these, there is a need to develop a social sustainability model that can mitigate default risk. Currently, the securitization of NPL's for small and medium-sized enterprises (SMEs) and households is driven by an approach that is oriented not towards restructuring but to foreclosure or repossession of debtors' assets. Because repossession is a driver, collections depend on real estate market trends, which in turn depend on macroeconomic performance. Recovery values are low because of an abundance of illiquid assets held by defaulted SMEs and households (mainly due to the effect of the 2007 crisis). In the medium term, this situation would cause a doom-loop that perpetuates a cycle where the most vulnerable continue to be excluded, assets depreciate and transferor banks face losses.

The situation described above counters a message from Caritas in Veritate, which reminds us that finance needs to go back to being "an instrument directed towards improved wealth creation and development" (CV n. 65). Its purpose is to connect those who have innovative ideas and require capital to bring them to life and those who have this capital and want to invest it. The financialization of the economy is therefore a deviation. In Pope Francis' words, "Finance overwhelms the real economy. The lessons of the global financial crisis have not been assimilated, and we are learning all too slowly the lessons of environmental deterioration." (LS 109). This is the economy that kills (EG 53).

Proposals

New rules, categories for risk-lending, sustainable solutions based on relationships, new public policies on home mortgages, more appropriate debt advisors

The following reforms could meaningfully transform the current system so that it works for everyone.

- *New and more stringent rules on loan origination* should be put in place worldwide; more specifically, a principle has to be affirmed according to which the lender has the responsibility to grant credit only to those who will reasonably be able to repay it without incurring financial distress.

- *The regulators* should be required to amend the current legal framework in Europe (including prudential treatment of NPLs) to allow and encourage the lender to analyse and take into consideration how the debtor might respond to negative events (e.g., redundancy, illness, other people's assistance needs), and make arrangements on how to handle such situations in a way that would *avoid the risk of social exclusion.*

- When a situation of over-indebtedness occurs or is at serious risk of occurring, financial creditors should be required to be proactive in providing *sustainable solutions*, such as *renegotiating the terms of the relationship* (e.g., extending the length of the financing, reducing the Annual Percentage Rate, granting moratoria, waving accrued interests).

- *Governments* should put in place *public policies* in order to ensure, especially with reference to *home mortgages*, that a family's over-indebtedness does not push the household into poverty.[1]

- *Debt advisors* play a crucial role in giving professional advice and finding the best solutions to help households get out of debt. Currently, there are only a fraction of the necessary qualified independent debt advisors available to support all the households in need. The Catholic Church, through its network of parishes, charities and services can engage in a greater role advocating and accompanying the needs of the most affected indebted households.

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