

Reforms of bankruptcy laws. The case of Germany*

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* The views expressed do not necessarily reflect the views of the Deutsche Bundesbank.

Outline of the presentation

- Some general considerations
- The institutional setting in Germany
- The empirical evidence

Some general considerations

Introduction

- **Consumer bankruptcy procedures provide insurance to households who suffer from bad luck (or from risky behaviour).**
 - The easier it is for consumers to discharge some (or all) of their debt, the greater the insurance.
- **The price of increased insurance, however, may be a more difficult access to external financing.**
 - Higher interest rates for borrowing.
 - Stricter collateral requirements.
 - Credit rationing.
- **The costs of default for consumers.**
 - Stigmatisation.
 - Probable future exclusion from credit market.
 - Part of consumer's (future) income may be seized.

Policy Leeway in Personal Insolvency Law

- **More creditor friendly procedure.**
 - Creditors recover as much of their credit as possible (absolute priority rule).
 - Preserves incentives for entrepreneurs to succeed before bankruptcy and for consumers to behave less hazardous.
- **More debtor friendly procedures.**
 - Providing discharge from debt when certain conditions are met.
 - Giving the bankruptcy person the chance of a new start and maintain to exert efforts after bankruptcy.
(such “fresh start” policies are widely considered to promote small business entrepreneurship).
 - Risk is shifted to lenders, who may react by charging higher interest rates, requiring stricter collaterals or (in the extreme case) rationing credit supply, that may hamper entrepreneurship (,which depends on capital) or consumption smoothing.
- **Policy decision: find an optimal balance between the interests of creditors and debtors.**

The institutional setting in Germany

The German Insolvency Law

- **1999: A new Insolvency Statute came into force.**
 - Discussion and preparation of insolvency law took a very long time (almost two decades).
 - Insolvency Statute replaced the Bankruptcy Act (of 1877).
 - Priority objective is **best possible satisfaction of creditors**.
 - At the same time, it aims at giving the **debtor the chance to recover from insolvency**.
- **Insolvency Statute provides special insolvency procedures for consumers.**
 - **Simplified procedure** for winding-up insolvencies of a natural person (or consumers).
 - **Previously self-employed persons** can use the special procedure only under two conditions:
 - (i) the number of creditors is not too large (usually interpreted as less than 20).
 - (ii) there are no claims from employer-employee relationships against the debtor.
 - Possibility of **discharge of residual debt** after a certain period of good conduct (“fresh start”).

The Steps of the Personal Insolvency Procedure (1)

- **Step 1: Attempt of extra-judicial settlements (Compulsory out-of-court negotiation).**
 - Debtor has to attempt to achieve an extra-judicial settlement with his creditors before he can file an insolvency request.
 - One reason: courts shall not be charged with too many insolvency proceedings.
 - The extra-judicial settlement can be **moderated by suitable persons or agencies**: lawyers, debtor advisory agencies of the welfare organisations or of local authorities (around 1,000).
- **Step 2: The judicial settlement plan-proceedings.**
 - If the extra-judicial attempt to reach a settlement with the creditors failed, the debtor can file a request to open insolvency proceedings.
 - Pre-condition: certification (of agency or lawyer) that out-of-court settlement failed.
 - Debtor has to submit a **settlement plan** and records of his assets, income, creditors and debt. The plan has to contain all provisions which are suited for an appropriate settlements of debt.
 - Court decides whether a court guided second attempt to reach a settlement between the debtor and the creditors could be successful.

The Steps of the Personal Insolvency Procedure (2)

- **Step 2: The judicial settlement plan-proceedings (cont'd).**
 - In case of a positive decision, the court serves the plan to debtor and all creditors.
 - If all creditors consent to or do not object to the plan within a month, the plan is deemed to be approved.
 - If majority of creditors have approved the plan and if the sum of their claims exceeds 50% of total claim, the court can replace the objections of the other creditors.
- **Step 3: Insolvency proceedings.**
 - If the judicial settlement plan fails (majority of creditors object it), the insolvency proceedings will be opened.
 - The court appoints a **trustee** who liquidates the estate of the debtor and **distributes the proceedings among the creditors.**

The Steps of the Personal Insolvency Procedure (3)

- **Step 4: Discharge proceedings**

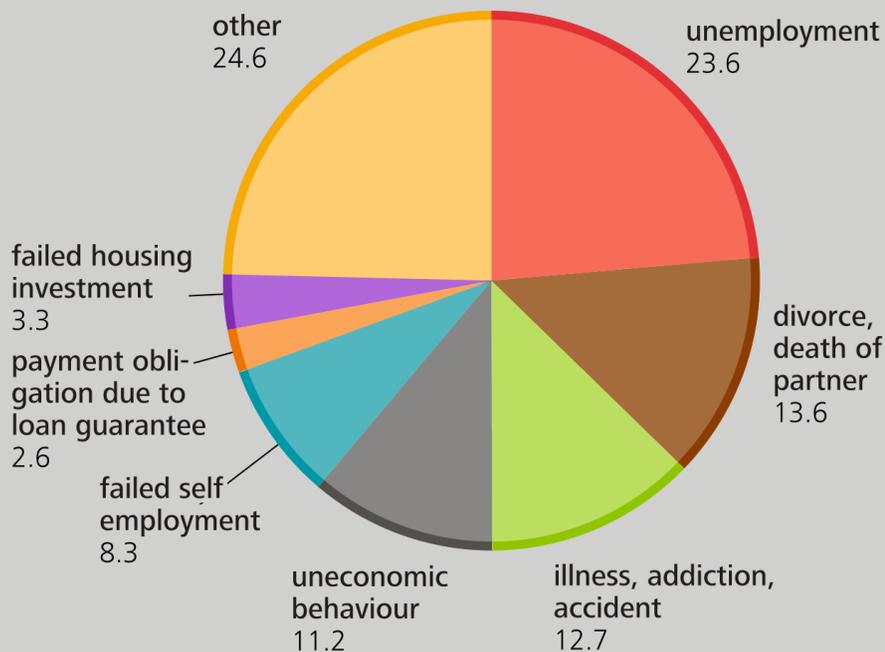
- The debtor may apply for admittance to the debt discharge option.
- If the court approves, the debtor has to fulfil several **conditions of good conduct** (a sizeable part of his income is distributed to the creditors and property may be seized as well).
- After 6 years, the court decides whether the residual debt is relieved (only possible once every ten years).
- Since 1 July 2014 debt discharge is possible already after 3 years, if the debtor has paid at least 35% of total claim. (incentive for the debtor, but also in the interest of the creditor).

The empirical evidence

Participation in debt counselling: Main reason of indebtedness

Main reason of indebtedness

Shares in %



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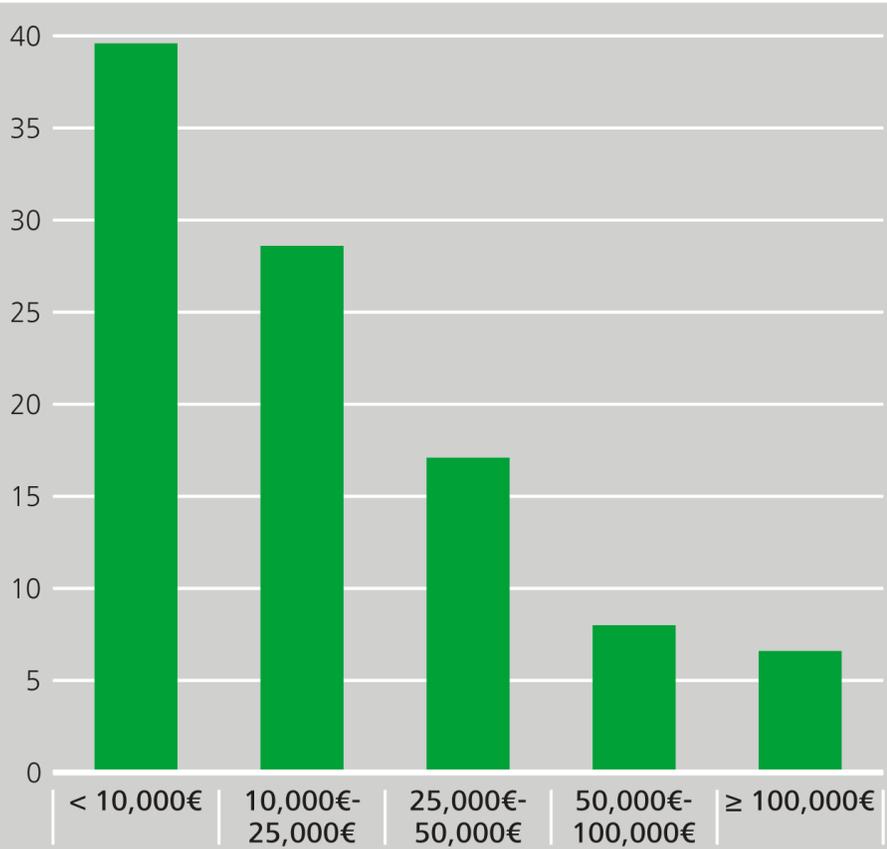
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- Most important triggers of severe debt problems are:
 - Unemployment.
 - Strokes of fate (divorce, death of partner, illness, accident).
 - Uneconomic behaviour.
- Failed activities (self-employment), housing investments or providing loan guarantees to other accounts for less than 15%.
 - Failed self-employment (8%).
 - Failed housing investment (3%)
 - Payment obligation due to loan guarantee (3%).

Participation in debt counselling: Claims against indebted persons

Claims against indebted persons

Shares in %



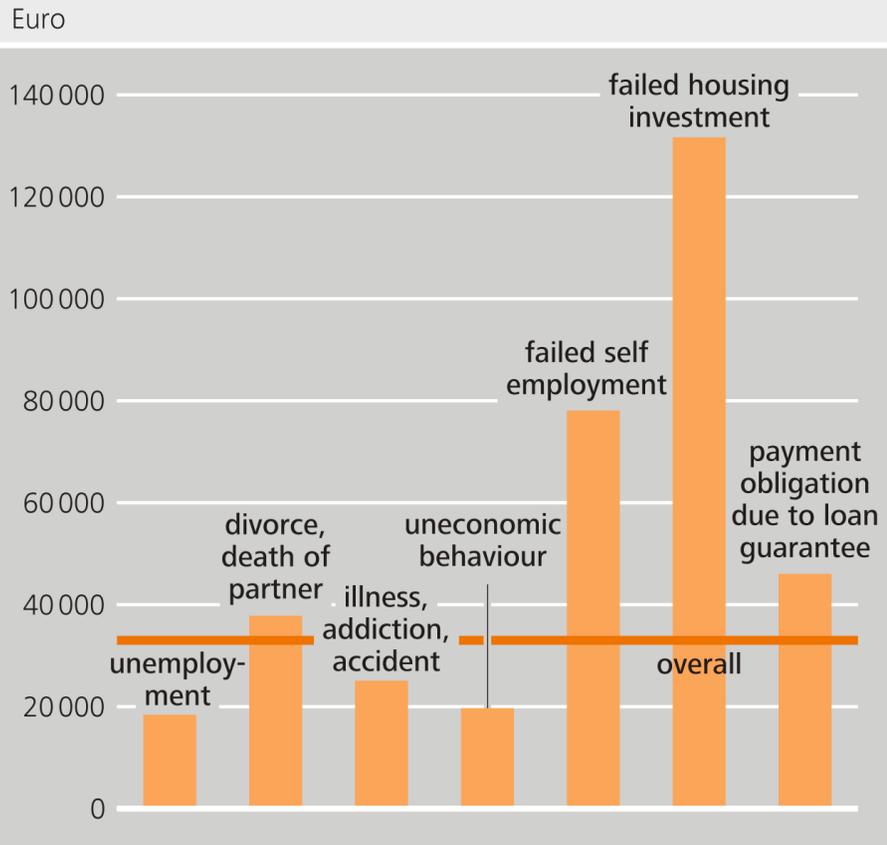
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- Majority of claims against indebted persons below € 25,000.
 - Nearly 40% below € 10,000.
 - Almost 30% between € 10,000 and € 25,000.
- Only 7% of indebted persons with a debt exceeding € 100,000.
 - In age brackets from 45 to 70 years this share is higher (11%).
- Average number of creditors:
 - 48% with 10 or more creditors.
 - 28% with 5 to 9 creditors.
 - 22% with 2 to 4 creditors.
 - 12% with just one creditor.

Participation in debt counselling: Average debt

Average debt according to main reason of indebtedness

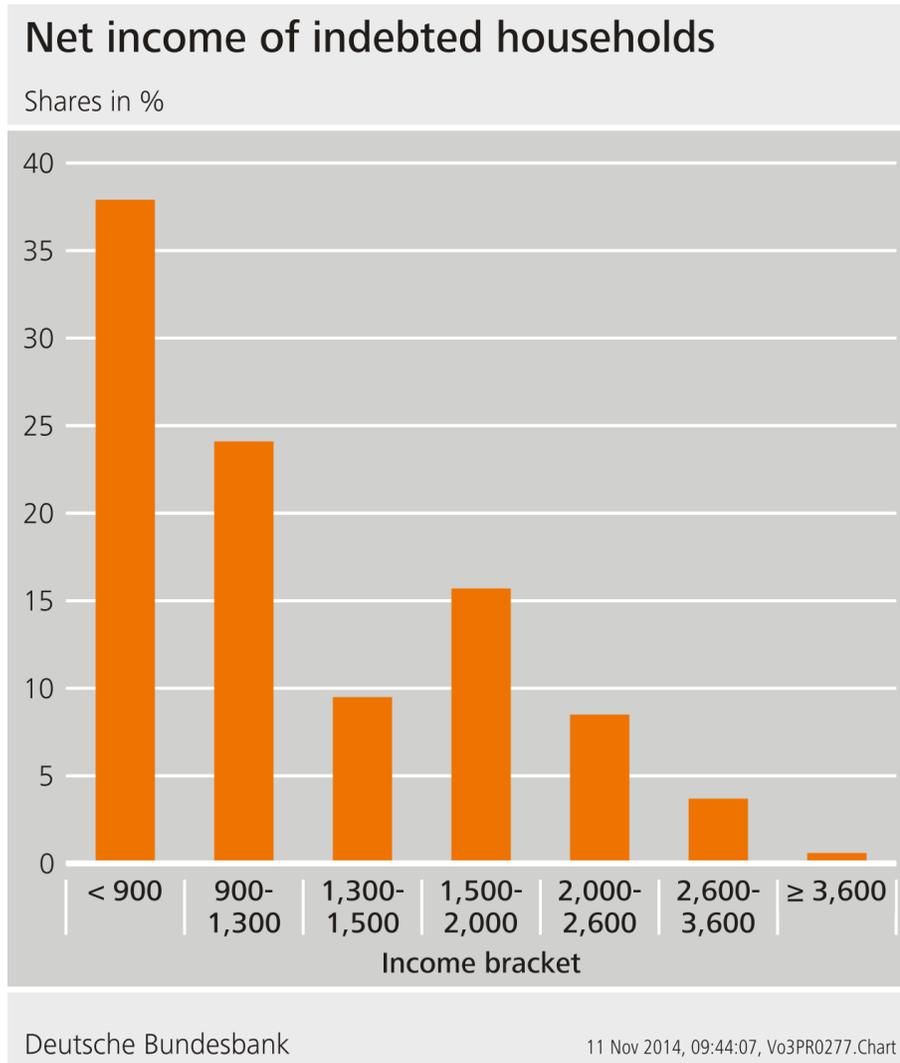


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- Average gross debt differs strongly with respect to main reason of indebtedness.
 - Average debt: € 33,000.
 - Persons with failed housing investment have by far the highest debt (€ 130,000).
 - Failed self-employment resulted also in a substantial indebtedness (€ 80,000).
- Slightly more than 50% of the debt is with credit institutions.
 - Debt collection agencies: 11%.
 - Public creditors: 10%.
 - Telecommunication firms: 3%.
 - Catalogue firms: 2%.

Participation in debt counselling: Households' net income

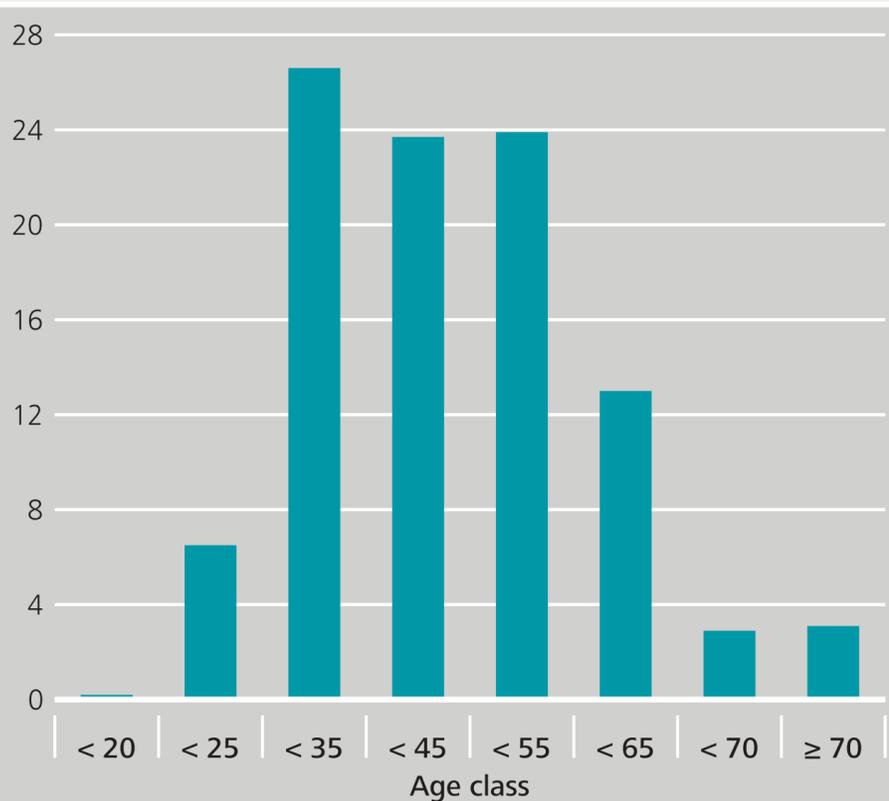


- Participation in debt counselling is negatively correlated with income.
- A large share of households participating in debt counselling have low incomes.
 - More than one-third below € 900.
 - One-third between € 900 and € 1,500.
- Higher-income households accounts only for a small fraction.
 - Just 0,6% of households using debt counselling have a monthly income over € 3,600.

Participation in debt counselling: Age structure

Indebted persons participating in debt counselling - Age structure

Shares in %



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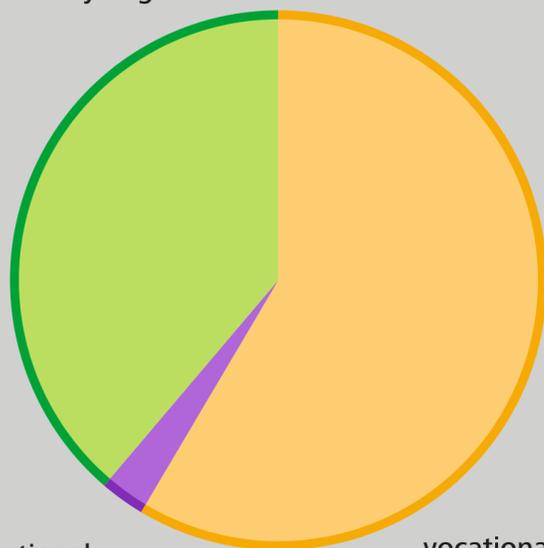
- Mainly middle-age groups are participating in debt counselling.
 - between 25 and 35 years: 27%.
 - between 35 and 45 years: 24%.
 - between 45 and 55 years: 24%

Participation in debt counselling: Vocational education and labour force status

Vocational education of indebted persons

Shares in %

without vocational
education / university degree
38.8



in vocational
education / university
2.7

vocational
education / university
completed
58.5

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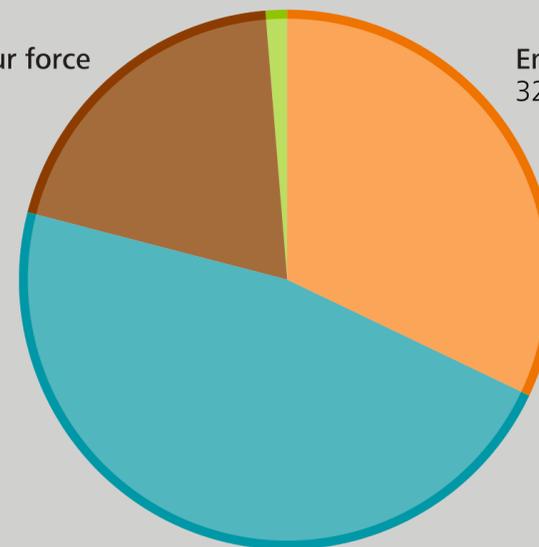
Labour force status of indebted persons

Shares in %

Self-employed
1.3

Out of labour force
19.7

Employed
32.1



Unemployed
47

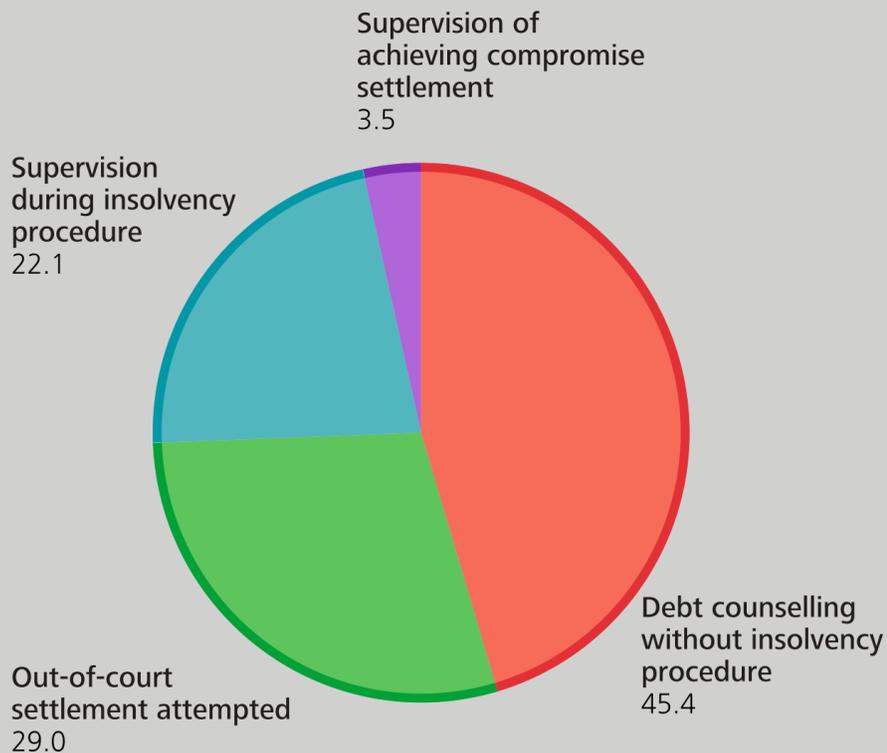
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Participation in debt counselling: Procedures not terminated

Procedures not terminated

Shares in %



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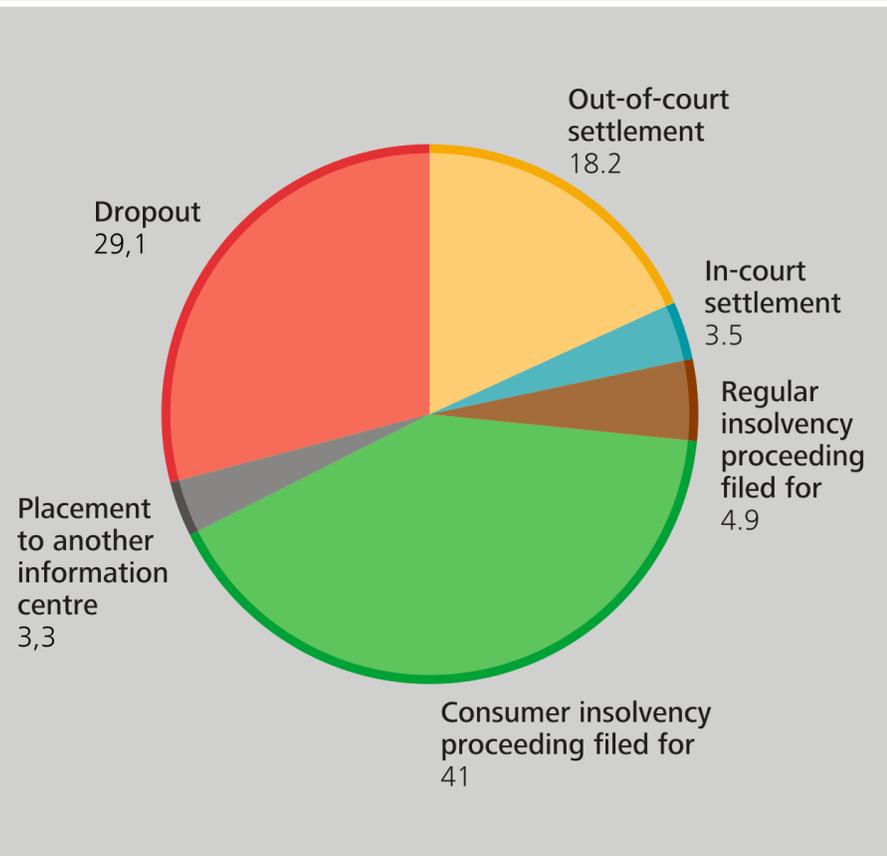
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- 63% of debt counselling with the debtor advisory agencies in 2013 have not been terminated in the same year.
- Among these non-terminated procedures debt counselling without an insolvency procedure (45%) and out-of-court settlements attempts (29%) accounts for three-fourths.
- In 22% of all cases, the debtor advisory agency assist the debtor during the insolvency procedure.

Participation in debt counselling: Terminated procedures

Terminated procedures

Shares in %

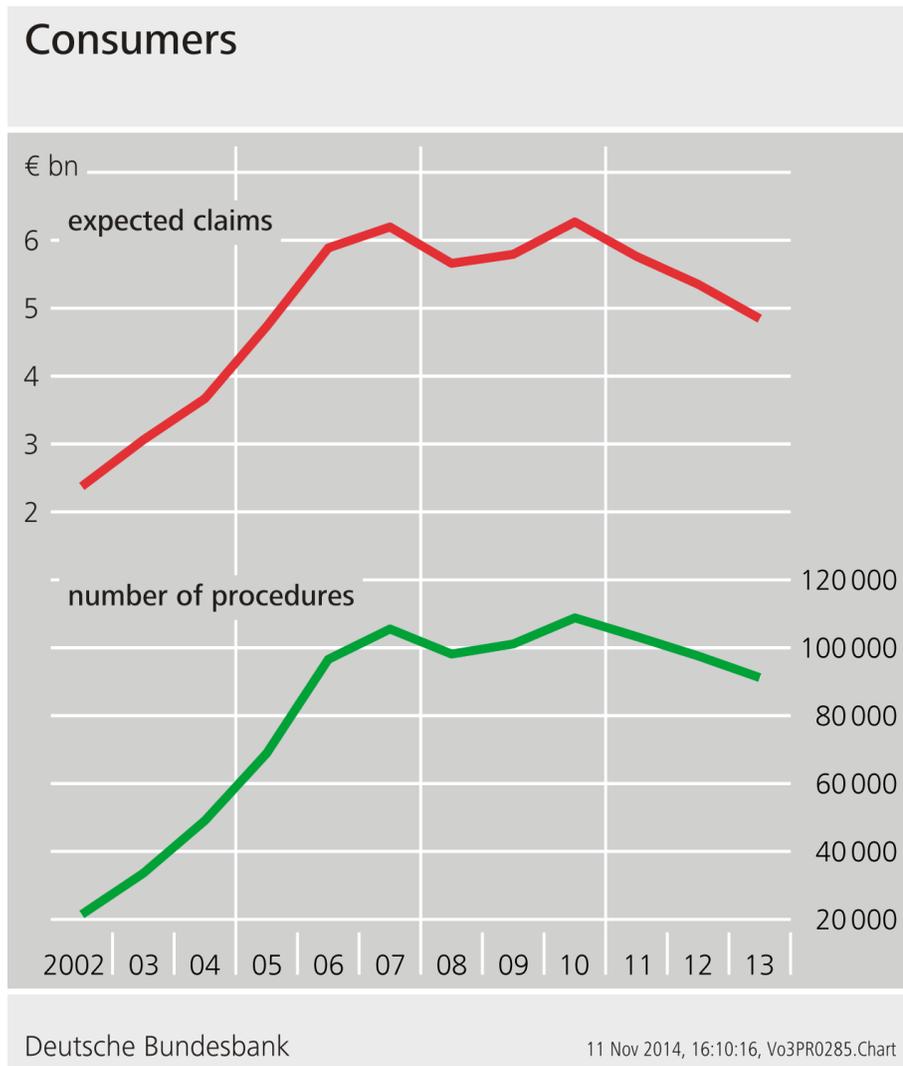


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- 37% of debt counselling with the debtor advisory agencies in 2013 have been terminated in the same year.
- Out of these terminated procedures
 - settlements (out-of-court and in-court) were reached for 22%.
 - consumer insolvency proceeding were filed for 41%.
 - regular insolvency proceedings were filed for 5% (mainly formerly self-employed that do not fulfil the criteria for applying for consumer insolvency).

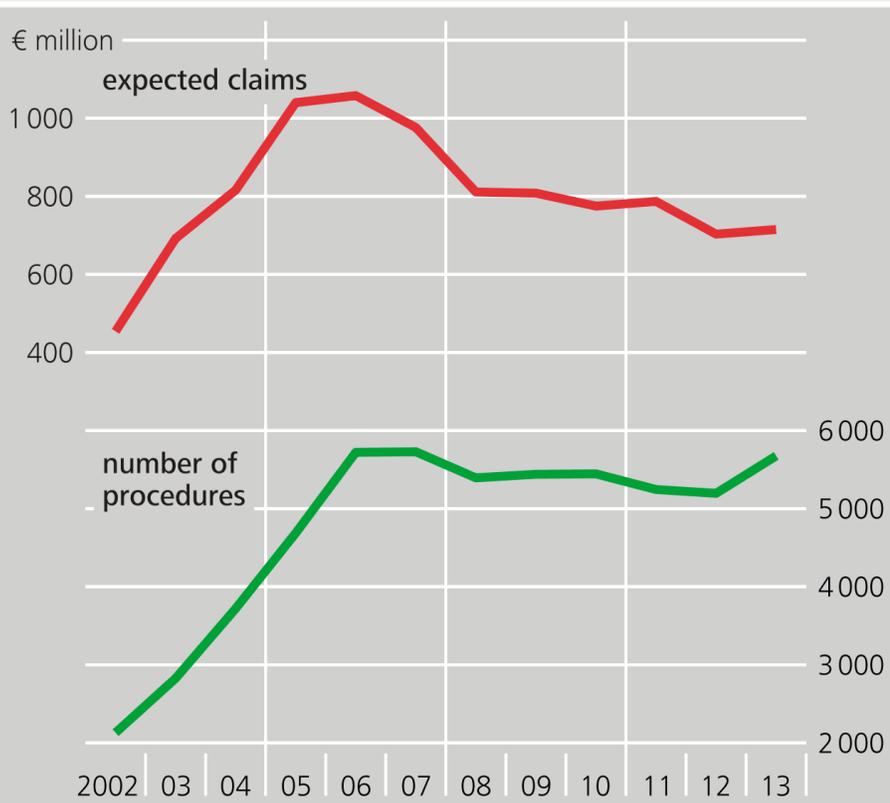
New insolvency proceedings: Consumers



- The annual number of new insolvency proceedings in Germany fluctuates around 100,000 cases since the middle of the previous decade.
 - approximately 0.15% of population above 18 years.
- The expected claims hovered around € 6 billion in the second half of the previous decade and declined to € 5 billion last year.
 - approximately 0.3% of gross debt of households.
 - Average expected claim per proceeding in 2013 around € 50,000.

New (simplified) insolvency proceedings of formerly self-employed persons

Formerly self-employed persons with simplified debt procedure or small wealth



- Number of new proceedings of formerly self-employed persons quite low.
- Expected claims in recent years less than € 1 billion.
 - Average expected claim per proceeding in 2013 slightly above € 100,000.

Empirical Studies for Germany

- **Almost all studies for Germany focus on regular bankruptcy law.**
- **Only one paper analysis the impact of personal bankruptcy law.**
 - *Fossen, F.M. (2011): Personal Bankruptcy Law, Wealth and Entrepreneurship; Theory and Evidence from the Introduction of a “Fresh Start”, IZA Discussion Paper No. 5459.*
 - **Question:** Impact of law (with debt discharge, introduced in 1999) on self-employment.
 - **Two (opposing) effects** of new law:
 - Increase attractiveness of entrepreneurship (“insurance effect”).
 - The risk is shifted to lenders.
 - Hypothesis: for **wealthy potential entrepreneurs** both aspects are less relevant.
 - Estimation of the effects on **entry into** and exit out of **self-employment**, where the effects of wealth is allowed to change with the policy shift.
 - If the impact of the wealth variable increase (decrease) with the reform, than less wealthy persons have a lower (higher) probability of entry into self-employment (relative to the wealthier households).

Empirical Studies for Germany (cont'd)

- Estimation method: discrete time hazard rate model (difference in difference estimator)
- Data: Socioeconomic Panel (SOEP), a household panel (for the years 1993 to 2004).
- Result: The (positive) effect of wealth declines with the introduction of the reform.
- Interpretation: The insurance effect of the more forgiving personal bankruptcy law dominates the effect of higher interest rates. Or in other words: the new law made entrepreneurship more attractive, especially for less wealthy people.



Thank you for your attention