

OVER-INDEBTEDNESS IN BRAZIL: DO WE NEED MORE REGULATION?

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I. Introduction

During the last decade, many Brazilian consumers left the lower strata of the socioeconomic pyramid and ascended to the middle class. A large part of this expanding social mobility came from increased access to credit. Easing the access to credit is considered by classic economic theory an important factor for economic growth and for contributing to economic well-being. Debt is necessary to maintain a stable consumption level and to boost economy in more timid periods. In Brazil, however, although borrowing led to a higher social status for some, for others it may have led to over-indebtedness.

This paper takes a law and economics approach to analyze over-indebtedness in Brazil and discusses the necessity of wider regulation of consumer credit. It firstly investigates data searching for signals related to the increasing indebtedness of Brazilian consumers. It became clear that, in the recent years, credit grew faster than income or individuals wage, raising their indebtedness rate and affecting the quality of loans. The information is relevant, but not enough to conclude over-indebtedness is happening in Brazil.

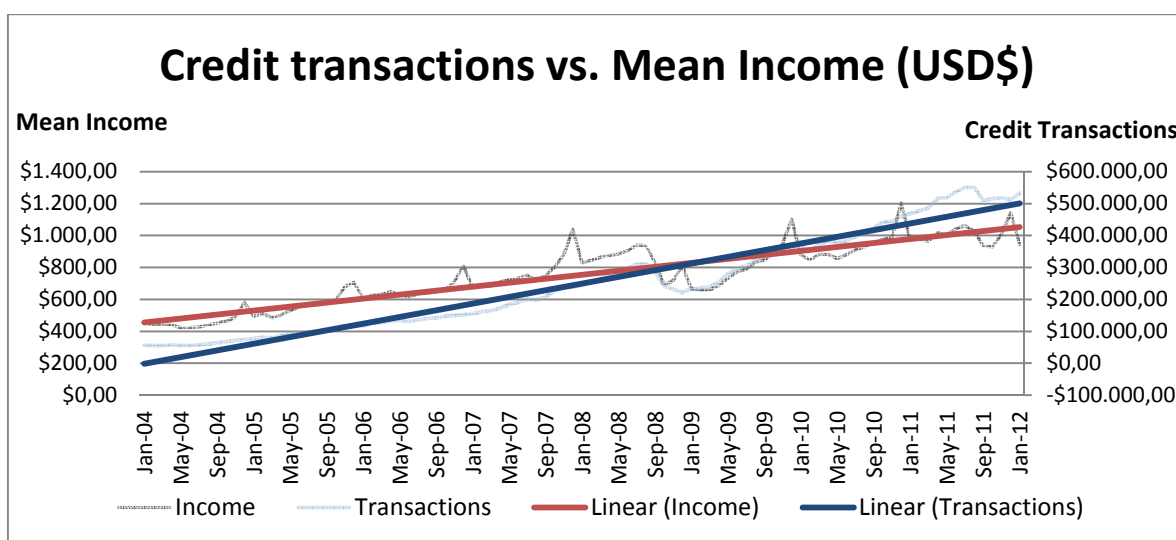
Secondly, it deals with some concepts of over-indebtedness presented by the literature. Despite the lack of a uniform definition made by scholars who have understood the subject, import conclusions can be drawn. These finds are also essentials in order to start to think about reasons and public policies for the matter.

Thirdly, different approaches and regulation forms applied in other countries are considered. There is an attempt to analyze some benefits and disadvantages of these systems, mainly of the American legal system. The aim of this section is to light possibilities of regulation to be used in different environments, questioning the possibilities of having success in another legal system.

After this first analysis, some of the behavioral law and economics biases are presented, together with their relation to consumer attitudes. All regulators have to take this analysis into consideration in order to achieve good results for their public policies in the sector, a discussion presented in section VI. Other aspects related to the regulation of over-indebtedness will also be considered in this last section.

II. Brazilian household's indebtedness overview

The amount of personal credit transactions and the indebtedness are increasing in Brazil. However, income rates do not follow the same rhythmus. In 2011, personal credit transactions reached almost the amount of USD\$ 560.000, while the mean income in the same period was of USD\$ 944.39. Basically, from January of 2004 to December of 2011, the mean income increased about 30%, while the amount of personal credit transactions raised about 500%.

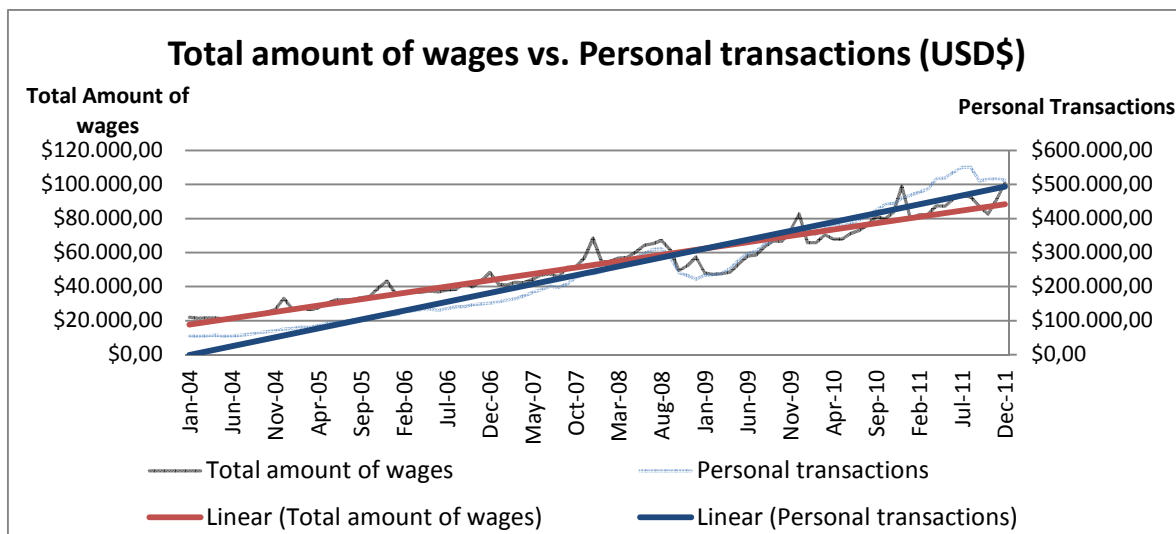


Graph 1: Relation between credit transactions and income ¹

When the amount of personal credit transactions is compared with the total amount of wages, the difference between them increases and is relevant. When the total wage mass available² at the beginning of 2004 is compared with the total wage mass available at December of 2011, an increase of about 359% is perceived. However, at the same period the increase of total personal credit transactions was around 813%. In this sense, the raise of the amount of credit transactions did not follow proportionally the increase of total income or the amount of wages. If these variables keep on this path, future income may not be - or is already not - enough for assuring the fulfillment of credit contracts and, consequently, consumer default may increase.

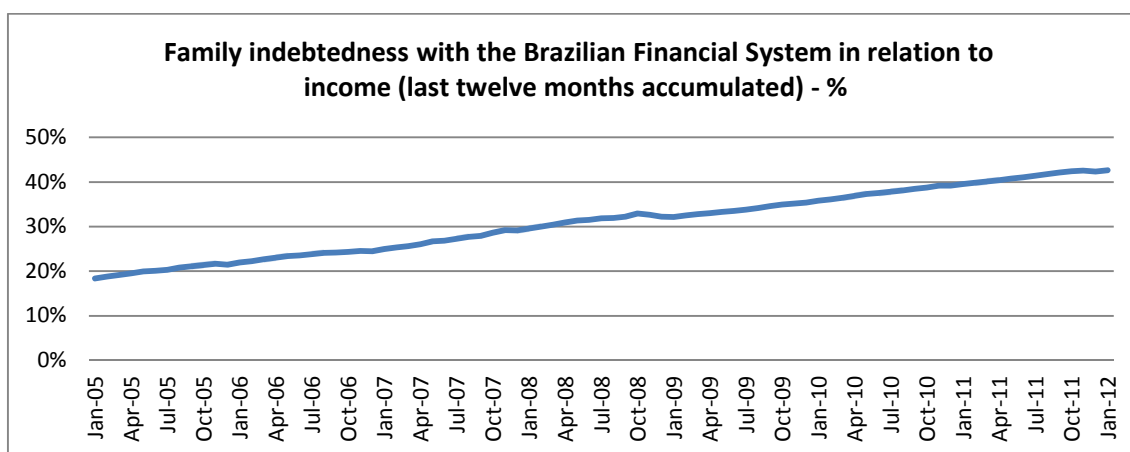
¹ In the graph, the blue line represents the deseasonalized total number of transactions and the red line the linear income (which does not consider extreme periods of time, such as December, when part of the 13th wage, mandatory according to the Brazilian Labor Law, is paid to employees). The gray line stays for the total income, considering seasonality variations. The data related to credit transactions were extracted from the Brazilian Central Bank website. Available at: <https://www3.bcb.gov.br/sgspub/localizarseries/localizarSeries.do?method=prepararTelaLocalizarSeries>.

² Wage mass available is the total wage mass minus the amount used only to pay taxes.



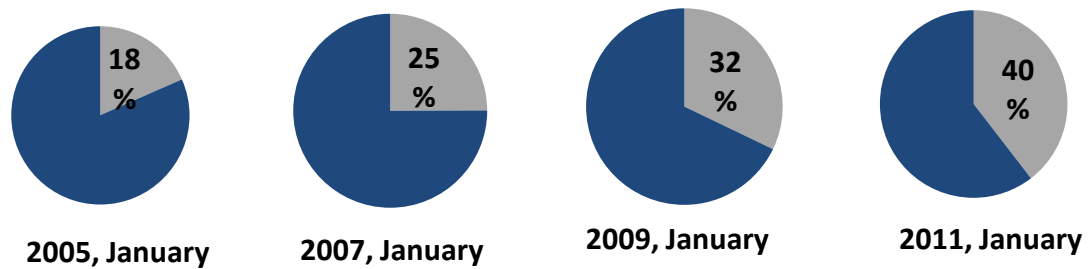
Graph 2: Relation between amount of credit transactions increase and total amount of wages

When personal indebtedness is analyzed from the family perspective, in relation to the cumulated income, a significant increase can be observed. In January of 2005 family indebtedness with the Brazilian Financial system - the percentage of their income compromised to the payment of their debts - was of 18.39%, while in January of 2012 it reached 42.66%. This represents an increase of almost 132%, as noticeable in the following graph.



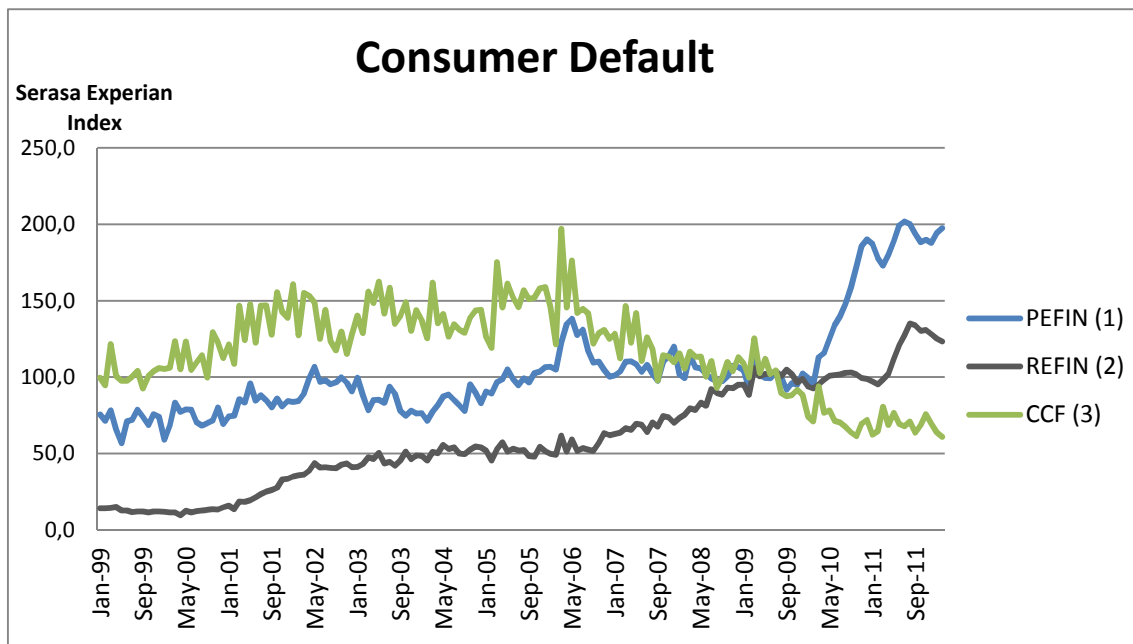
Graph 3: Family indebtedness with the Brazilian Financial System in relation to income (last twelve months accumulated)³

³ Source: Economic Department of the Brazilian Central Bank (BCB Depec). Available at <https://www3.bcb.gov.br/sgspub/localizarseries/localizarSeries.do?method=prepararTelaLocalizarSeries>.



Graph 4: Family indebtedness increase

Index 1, of graphic 5, indicates there was a significant increase on the monthly flow of registered delayed debts in the financial institutions, credit cards operators and non-financial ones. Index 2, points the monthly flow of registered delayed debts increased meaningfully. Mainly, when the first months of 2010 are analyzed, the increase is strongly perceived, which indicates a high indebtedness rate in those months. The third index, representing the monthly flow of bounced checks for insufficiency of funds, is not so economically significant, especially because the use of checks is being replaced by other paying means, as credit cards. As a consequence, this variable may be poisoned, since the use of check itself is not anymore widely popular.

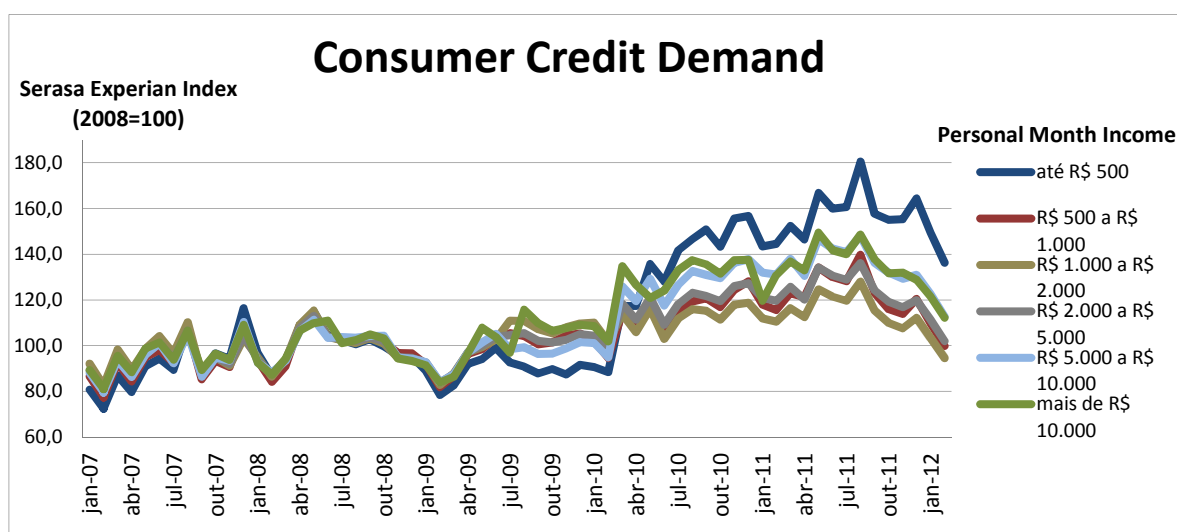


Graph 5: Consumer Default ⁴

- (1) Monthly flow of registered non-paid debts at financial institutions, credit card operators and non-financial institutions
- (2) Monthly flow of registered non-paid debts in the banks
- (3) Monthly flow of bounced checks (2nd devolution)

⁴ These data are part of a research developed by Serasa Experian, since 1999. Available at: http://www.serasaexperian.com.br/release/indicadores/inadimplencia_consumidor.htm.

Graphic 6 highlights a strong period of credit demand as shown above. If one considers the personal monthly income of the lower income borrowers, one will notice that these classes of consumers have been increasing the amount of acquired credit more rapidly than others classes of consumers. Indeed, all classes of income ranges were closely together with regard to the amount of credit demand until July of 2010. After that date there was a strong demand for credit by the class of low-income consumers (until R\$ 500). In general, the demand for credit of this specific class of low-income consumers has been increasing more than others. Further, a strong seasonality can be perceived by analyzing Graph6: high demand peaks are followed by more timid demand periods repeatedly.

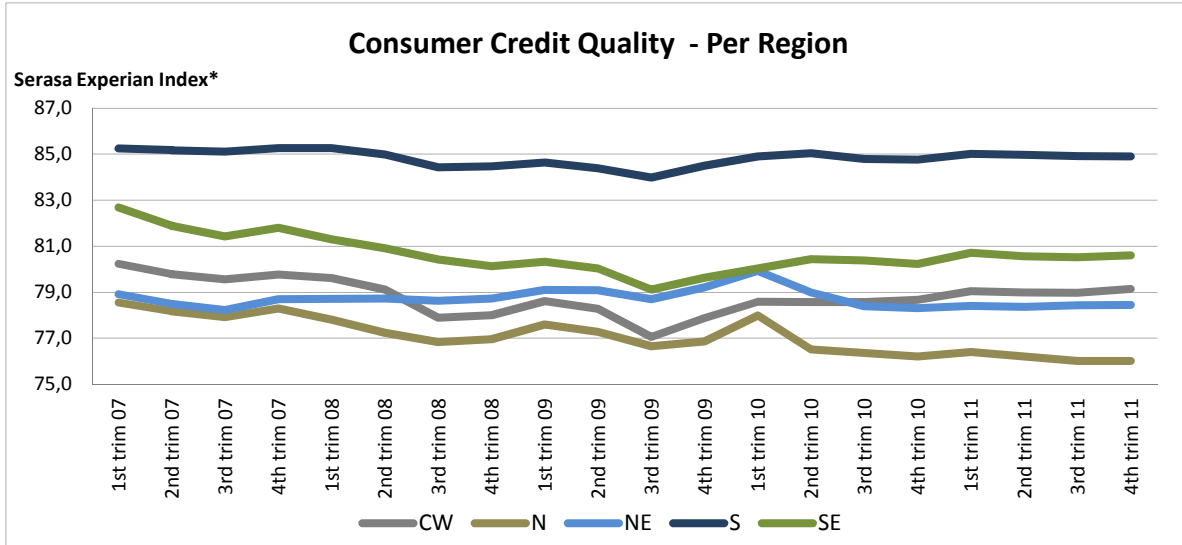


Graph 6: Consumer Credit Demand ⁵

Another indicator, developed by Serasa Experian, analyses the consumer credit quality. Data collected since 2007, considering income range and geographic areas, allow an evaluation of credit quality. According to Serasa criteria nearer to 100, smaller is the chance of default. Following this criterion, one can notice that results indicate a worsening of credit quality to all income ranges consumers classes. Although, the most significant variation on consumer credit quality is perceived in the income ranges of until R\$ 500 and between R\$ 1.000 and R\$ 2.000. Considering Brazilian main geographic areas, South presents the best performance of all regions. At the same time, north is the worst evaluated. In general, credit quality got worse in all regions in the period. Even so, after the peak perceived in the first quarter of 2010, north and northeast regions had the credit index quality more affected.

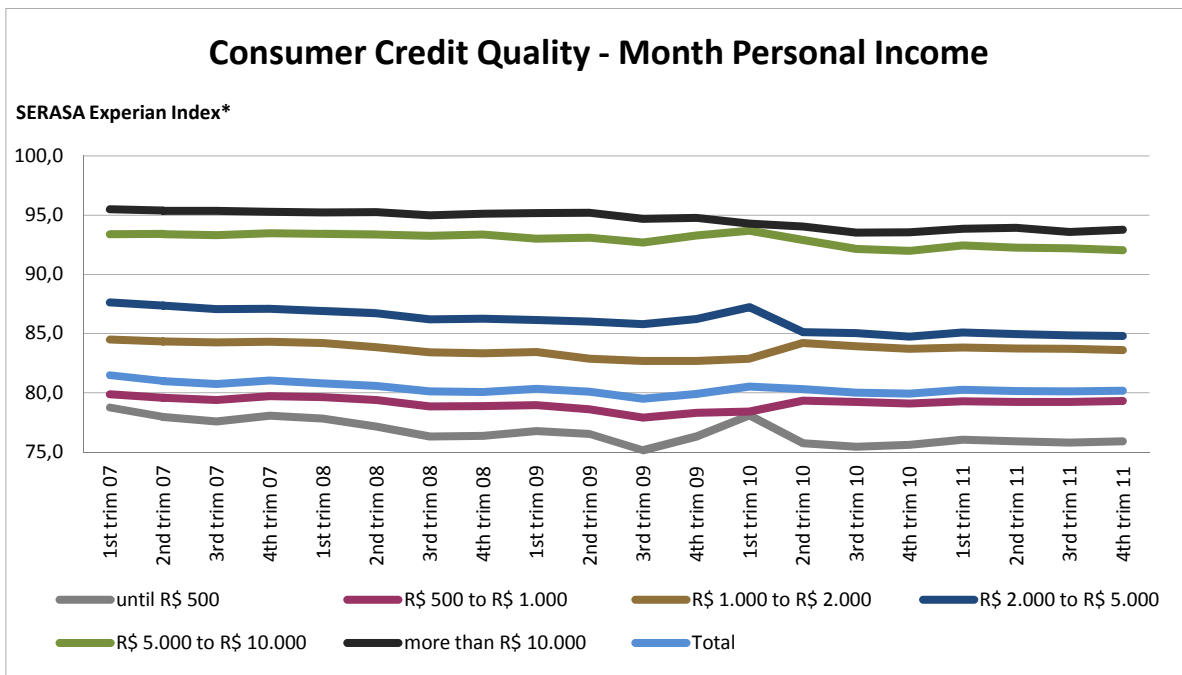
⁵ *Ibid.* Available at http://www.serasaexperian.com.br/release/indicadores/demanda_pf_credito.htm.

Work-in-progress



Graph 7: Consumer Credit Quality – per Region

* This index varies from 0 to 100, where the closer to 100 the number is, the better is the credit quality (lowest probability of default)



Graph 8: Consumer Credit Quality - Monthly Personal Income

The analysis of these data points to a higher personal indebtedness scenario, in which future income may not be enough to assure the payment of these debts. Credit demand and default have also raised and credit quality is generally worsening. Although a critical background is perceived it might get even more problematic, if no further action is taken. The existence of over-indebtedness in Brazil is not yet proven, but there are signs on the data that can be

interpreted as evidences of over-indebtedness. The diagnosis of personal over-indebtedness in Brazil certainly depends on the adopted concept of over-indebtedness, which is not uniform in the literature. As an attempt of delineating this problem more precisely, the next Section will deal with some definition of over-indebtedness.

III. The concept of over-indebtedness

Over-indebtedness has been widely discussed in different countries. The origin of this discussion lies on the increasing number of individuals considered over-indebted according to different definitions. In Germany, for instance, 3.13 million individuals were over-indebted in 2002 as announced by the GP Forschungsgruppe⁶. In Brazil there is, however, a lack of consolidated data and studies in the area. Nevertheless, many scholars have been understanding over-indebtedness in different ways and a uniform definition has not yet been established.

According to one of these definitions, over-indebtedness means “the impossibility to repay all debts fully and on time”⁷. This understanding is similar to the concept of insolvency provided by the German Insolvency Code: “the current or future impossibility to amortize the debts on schedule”.⁸ In the German system, the civil code empowers the creditor to cancel credit agreements if there are, at least, two installments overdue. This cancellation of the credit agreement is responsible for formally constituting an over-indebted status. Still according to the author, getting over-indebted involves three main steps. Firstly, there is a previous precarious financial situation: debts were cumulated and there may be illiquidity. Secondly, outstanding accounts and credit cards may be cancelled, turning over-indebtedness into a visible situation. Finally, an insolvency proceeding starts and a declaration of inability to pay assures an open over-indebtedness situation.

Moreover, according to others, an individual is over-indebted when his liabilities overcome his assets, meaning that financial and economic help are needed⁹. The French legislation defines it as the impossibility of the good-faith debtor to pay his non-professional debts¹⁰. However, the amount of debts is not determined, nor a specific profile of the over-indebted. Similarly, over-indebtedness can be understood as the global impossibility of the individual (good-faith consumer) at paying his current and future debts, excluding the tax, food and criminal ones.¹¹ Some even affirm that the extension of the concept is necessary, in order to include consumers who did not acquire credit¹².

When analyzing the main definitions, some conclusions follow. Only natural persons get over-indebted; when dealing with legal persons, there are specific procedures as bankruptcy and rescue of viable companies. Moreover, the simple momentary illiquidity does not characterize over-indebtedness: a deeper analysis of the assets, individual revenue and

⁶ HAAS, Oliver J. Overindebtedness in Germany. Working Paper n° 44. International Labour Office. Employment Sector – Social Finance Program. p. 7.

⁷ *Ibid.* p. 3.

⁸ Insolvenzordnung (InsO), § 17, § 18. *Apud.* HAAS, Oliver J. Overindebtedness in Germany. Working Paper n° 44. International Labour Office. Employment Sector – Social Finance Program. p. 4.

⁹ CARPENA, Heloisa; CAVALLAZZI, Rosângela Lunardelli. Superendividamento: propostas para um estudo empírico e perspectiva de regulação. In: MARQUES, Cláudia Lima; CAVALLAZZI, Rosângela Lunardelli (Coord.) Direitos do Consumidor Endividado: Superendividamento e crédito. São Paulo: RT, 2006. p. 329.

¹⁰ Art. L. 330-1 of the French Consumer Code.

¹¹ MARQUES, Cláudia Lima. *Apud.* NETO, André Perlin Schmidt. *Op. Cit.* p. 170.

¹² MELLO, Flávio Citro Vieira de. A Proteção do Sobre-endividado no Brasil à luz do Direito Comparado. *Revista Luso-brasileira de Direito do Consumo*, Vol. I, n. 2, junho de 2011, p. 16.

cumulated liability is also necessary. If the debtor is capable of paying by some possible means, there is no over-indebtedness. Consequently, if there is credit available in the market and an insolvent individual has access to it, he is not yet, technically, over-indebted. In this sense, it is crucial analyzing the amount of credit available in the market and the conditions for individuals to use it.

Also the concept of good faith is essential for defining over-indebtedness: if an intention of getting over-indebted is noted, should any type of protection be granted to this individual? As a consequence of this question, future regulation and protection should be tailored to specific consumers or widely applied.

Considering these aspects, there are two types of over-indebted: active and passive ones¹³. In the first case, consumers get voluntarily indebted. They may be consciously active over-indebted, meaning that they get intentionally indebted, aiming not to pay since the contract celebration. On the other hand, the unconscious active over-indebted consumer purchases in an impulsive way without correctly controlling his balance sheet. Differently, passive over-indebtedness results from external and unpredicted factors, such as unemployment, divorce, illness and change in the economic scenario. In this case, consumers overvalue their paying abilities. Therefore, easing credit access may be harmful for such consumers, since they are not able of correctly supervising their debts.

When determining some criteria for defining over-indebtedness, social and personal factors may be considered. As social factors, one may consider job loss and durable unemployment, business failures, income-poverty, separations or divorce and illness. On the other hand, personal factors such as insufficient financial literacy, excessive consumption, inappropriate financial services and addiction are also relevant.¹⁴ Some numbers tend to show that, globally, over-indebtedness is more related to social factors. A German Institute for Financial Services research, for instance, concluded that over-indebtedness is, in most cases, a consequence of income-poverty.¹⁵ Still, researches in Brazil indicated that passive over-indebtedness, caused by income changes, is the most frequent species. According to a research conducted in the State of Rio Grande do Sul involving 100 cases, more than 70% of the individuals become over-indebted because of unpredicted incidents, such as unemployment, death of relatives, divorce, family illness and kids.¹⁶ Other sources mention even higher percentages caused by unpredicted incidents: 80%¹⁷ and 84.5%¹⁸ of the cases in Rio Grande do Sul and 73% in Rio

¹³ NETO, André Perlin Schmidt. *Superendividamento do Consumidor: conceito, pressupostos e classificação*. Available at http://www4.jfrj.jus.br/seer/index.php/revista_sjrj/article/view/36/34. p. 173.

¹⁴ HAAS, Oliver J. *Op. cit.* p. 13.

¹⁵ *Idem*.

¹⁶ MARQUES, Cláudia Lima. Sugestões para uma Lei sobre o Tratamento do Superendividamento de Pessoas Físicas em Contratos de Crédito de Consumo: proposições com base em pesquisa empírica de 100 casos no Rio Grande do Sul. In: MARQUES, Cláudia Lima; CAVALLAZI, Rosângela Lunardelli (Coord.). *Direitos do Consumidor endividado: Superendividamento e crédito*. São Paulo: RT, 2006. p. 302.

¹⁷ CONSALTER, Rafaela. *Apud*. NETO, André Perlin Schmidt. *Superendividamento do Consumidor: conceito, pressupostos e classificação*. Available at http://www4.jfrj.jus.br/seer/index.php/revista_sjrj/article/view/36/34. p. 178.

de Janeiro¹⁹. Also in the United States of America this prone exists: empirical data suggests that medical, divorce and job interruption cause most of the cases of bankruptcies in the U.S.A.²⁰.

Furthermore, it is worth noting that the causes of over-indebtedness can be divided in three main phases. In the pre-contracting phase, problems related to the credit supply may arise. For instance, if the offers are not clear and ostensive, they may lead to a high degree of asymmetry between creditor and debtor. In the contractual phase, on the other hand, the presence of high interest rates and monetary restatement may raise concerns. At last, the post-contractual phase counts with specific norms related to the debtors' registration in negative data basis and to appropriate charging. This distinction, although of small relevance for delineating an over-indebted consumer profile in Brazil, may help the treatment of over-indebtedness while no specific regulation is approved by the Brazilian Congress, as well as adopting available legal mechanisms.

¹⁸ LIMA, Clarissa de and BERTONCELLO, Karen. *Apud.* NETO, André Perlin Schmidt. *Superendividamento do Consumidor: conceito, pressupostos e classificação.* Available at http://www4.jfrj.jus.br/seer/index.php/revista_sjrj/article/view/36/34. p. 178.

¹⁹ NETO, André Perlin Schmidt. *Superendividamento do Consumidor: conceito, pressupostos e classificação.* Available at http://www4.jfrj.jus.br/seer/index.php/revista_sjrj/article/view/36/34. p. 178.

²⁰ SULLIVAN, WARREN, and WESTBROOK. *Apud.* DICKERSON, A. Mechele, Consumer Over-Indebtedness: A U.S. Perspective (October 2, 2008). *Texas International Law Journal*, Vol. 43, 2008; U of Texas Law, Law and Econ Research Paper No. 157. Available at SSRN: <http://ssrn.com/abstract=1496571>. p. 146.

IV. Over-indebtedness and Bankruptcy in the United States, in European countries and in Brazil

The problem of over-indebtedness has been a concern for many scholars in different countries. In the U.S., the great difference between what Americans produced and what they consumed in 2006 was almost like the Brazilian entire annual output in the year and, therefore, has been considered a main issue in the direction of over-indebtedness²¹. Likewise, in 2006, total U.S. household debt was \$ 12.8 million and debt has risen faster than income for American middle-income families²². This situation indicates that credit may be used to paying for health care, college tuition and housing, finance present consumption without clearly knowing how the acquired debts will be paid in the future²³. As a consequence, the American saving rates have been negative since 2006²⁴. However, differently from Brazil, the U.S. legal system includes a Bankruptcy Code, which is commonly used for dealing with over-indebted consumers. Even so, this Code is constantly criticized for allowing consumers to rid themselves of some of their debts²⁵.

Many aspects help leading to a general over-indebted situation. In the U.S., credit cards are used by the huge majority of the population. Credit cards debts are correlated with consumer bankruptcy filings; however, the reasons for increasing credit card debts are not clear. The deregulation of credit cards and other consumer credits is strictly connected to it, but it does not explain why consumers rationally choose getting excessively indebted. One of the reasons may be related to the information asymmetry between creditors and borrowers. Some borrowers do not understand credit card as a means of borrowing, because the amount of credit can be fully paid without interest²⁶. Those who view it as a form of borrowing, mostly, do not correctly understand billing terms²⁷. Despite of consumers lack of understanding, behavioral economic biases are also relevant when analyzing the reasons for excessive borrowings. The fact that many people tend to overestimate their ability to exercise self-control, as well as the real means of repaying in the future, become relevant in this scenario.

However, not only the exaggerated use of credit card is essential in this discussion. The U.S. Government incentives made lenders developed loan products turning mortgage credit more available to lower income high risk consumer²⁸. As a consequence of the credit democratization process, financial institutions gave higher risk borrowers access to credit in the form of non-traditional mortgage products. The government's attitude, however, had the support of a legal prevision: a formal consumer insolvency regime, valid since 1898. In this sense, consumers can seek formal financial help intending to discharge some of their debts.

²¹ DICKERSON, A. Mechele, *Op. cit.* p. 136.

²² *Ibid.* p. 137.

²³ *Idem.*

²⁴ *Idem.*

²⁵ *Ibid.* p. 136.

²⁶ *Ibid.* p. 137.

²⁷ According to A. Mechele Dickerson, 'Many of those who understand that a credit card transaction is a loan do not understand credit card billing terms because (a) pertinent information is not effectively disclosed (*i.e.*, a lack of transparency); (b) the complexity of the terms makes it virtually impossible for the average consumer to understand the true cost of the credit; or (c) because the terms change frequently'. *Ibid.* p. 138.

²⁸ Li and Yao. *Apud.* DICKERSON, A. Mechele. *Op. cit.* p. 140.

The *ratio* behind the Code relates to the recognition of the impossibility of an individual consumer renegotiate all of his debts with numerous different creditors unless these are legally forced to accept a payment plan²⁹.

Nevertheless, in order to incentivize consumers to change their spending habits and to force them to live with the consequences of their choices³⁰, the American Bankruptcy Code has been changed in 2005 by the Bankruptcy Abuse Prevention and Consumer Protection Act (BAPCPA). Filing for bankruptcy became more difficult and, as a consequence, consumers should have become more aware of the moral duty related to spending decisions. Before this Act passed, consumers could easily decide between repaying their debts in a period of three to five years (compromising their future revenue), adopting Chapter 13, or discharging their debts with no aim of repayment (under Chapter 7)³¹. There was no clear incentive for consumers to attempt to adopt a repayment plan, since Chapter 7 was as well an available option (under Chapter 7, the presentation of a payment plan was not necessary). Still, the positive aspect of Chapter 13 involves avoiding foreclosure procedures.³²

Another relevant aspect of the change refers to the mandatory credit counseling before filing a bankruptcy petition and to the necessity of Chapter 13 debtors receiving financial management training from financial educations. However, some authors point that pre-filing credit procedure is insignificant for most consumers, because at the time of a bankruptcy filing the financial situation is way too serious to be solved by simple counseling. As affirmed by Dickerson, the overwhelming majority “of debtors who participated in pre-bankruptcy counseling simply did not have enough money to pay their bills, or do anything else except attempt to get relief for their over-indebtedness by filing for bankruptcy”³³. However, the counseling procedure failed not only with regard to over-indebted consumers, but also to counseling service agencies, because the activity is not financially profitable considering the legal requirements. Despite of these, under the Act, the number of documents to be presented before and during bankruptcy increased. Further, the cost of the whole process is higher, since lawyers must spend more time working at it and filing fees are higher.

With regard to the consumers protected by the Act, many of the over-indebted were spared by the rough consequences brought by BAPCPA. For instance, the ones who get indebted proven by medical bills connected to serious medical diseases and conditions³⁴. Some members of the armed forces are also exempted from BAPCPA requirements.

As a consequence of the whole legislation change, some numbers are presented by Dickerson: while there were over 1.5 million filings in 2004 and over two million in 2005, in 2006 fewer than 600,000 bankruptcy reliefs were filed³⁵.

²⁹ DICKERSON, A. Mechele. *Op. cit.* p. 144.

³⁰ *Idem.*

³¹ *Idem.*

³² MELLO, Flávio Citro Vieira de. *Op. Cit.*, p. 30.

³³ *Ibid.*, p. 149.

³⁴ *Ibid.*, p. 146.

³⁵ DICKERSON, A. Mechele. *Op. cit.* p. 147.

In France, only the good faith consumer is protected by the legislation. The system gives special attention to extrajudicial administrative conciliation before governmental commissions and a payment plan (lasting no more than 8 years) can be created with no judicial intervention.

While there is a constantly applied Insolvency Code in the U.S., in Brazil there is only specific prevision of civil insolvency in the Civil Procedure Code and in the Civil Code, which is empty of efficacy. There is no specific legislation regarding over-indebtedness. In this regard, authors affirm that the problem, as a social phenomenon, does not receive the necessary attention from the government branches³⁶. The insolvency can be declared against insolvent debtors, when their balance sheets point to a state of insolvency. When the economic insolvency is proved, a judicial decision will declare it and a new regime starts. All of the creditors take part in the 'universal execution' of the debtor with the intention of accessing all of the debtor's available goods. The Brazilian insolvency judicial procedure has many features, such as the appointment of an administrator who is judicially empowered to represent the debtor assets and manage them. Moreover, it is relevant noting that only non-preferential creditors, who do not count with any kind of guarantee, are allowed to start an insolvency procedure. However, if a privileged creditor opts to waive his guarantees, this is also possible if previously communicated to the debtor.

The civil insolvency judicial procedure involves many steps. After being summoned, the debtor has ten days to oppose to the process. In the meantime, he can pay his debts; choose neither to pay, nor to oppose (in this case, the judge will decide in ten days); oppose intending not to pay his debts; oppose showing that his assets overcome his debts; or, finally, deposit the amount of money required, demonstrating that there is no real insolvency³⁷. If the debtor himself requires his insolvency, the initial application, despite of the regular content, shall also include a list of the debtor's goods with estimated values and a report of his balance sheet with the reasons responsible for leading him to the state of insolvency. The judicial decision declaring insolvency has as consequences the advance expiry of all of the debts.

The procedure, despite of some advantages, is not commonly used by creditors or debtors. From the debtor's perspective, one of the issues related to it is the long period of five years, after which the non-paid debts will expire if the debtor does not pay them on time. According to the President of the Brazilian Institute of the Consumers Relations Defense (Ibedec), Geraldo Tardin, "the procedure is not simple or fast, but it is a radical solution, which the debtor can choose for restarting"³⁸. In this sense, the debtor must be prepared for serious consequences, because between the insolvency requirement, its declaration and the five year period of the debts expiries, the consumer may have no access to credit for ten years, including credit cards, bank services and overdraft banking.

³⁶ MELLO, Flávio Citro Vieira de. *Op. Cit.*, p. 3.

³⁷ TORRES, Rodrigo Andrés Carmona. Aspectos gerais da insolvência civil. Available at <http://jus.com.br/revista/texto/8425/aspectos-gerais-da-insolvencia-civil>.

³⁸ *Pessoa Física também pode pedir Falência*. Available at <http://www.acaocomunitaria.org/1.0/index.php/noticias/40-consumidor/181-pessoa-fisica-tambem-pode-pedir-falencia>.

The purchase of goods and immovable properties may be restricted, since there is the risk of creditors asking for them in order to see their credits satisfied. Also, there is no prevision related to the formulation of a payment plan, including possible partial and total reliefs. The psychological and moral aspect also influences the attempt of debtors to avoid the insolvency procedure. Debtors are afraid of the *stigma* created by the insolvency declaration. In an interview with the public defenders, members of the Consumer Defense Center of Rio de Janeiro³⁹, Tatiana Passos and Larissa Ellias highlighted the shame of the over-indebted consumer before his family and friends. From the creditor's point of view, the judicial procedure involves a high cost⁴⁰.

These factors show that trying to negotiate possible installments may be a better solution, instead of starting an insolvency procedure, which would probably unable the access to credit for an extremely long period. However, there is no legal prevision involving the creation of non-judicial renegotiating plans and the payments of debts or granting an effective relief of the debts. Still, another possible solution to the ones dealing with high interest rates issues is to file a lawsuit, intending to revise the applicable interests⁴¹.

Despite of the lack of specific regulation and the practical small number of civil insolvency procedures, there are legal institutes that may be used for trying to deal with situations in which the consumers' dignity is directed affected. In this sense, the Brazilian Law prohibits the wage garnishment⁴² and the seizure of family goods (Law 8.009/90). Consumers can only be registered in negative data base for no longer than 5 years⁴³ and they are protected from abusive and constraining charging⁴⁴. For consigned credit, the debt cannot be greater than 30% of the loan or civil servant pension⁴⁵. The Courts have already understood that this limit is valid also for banking loans with current account debits⁴⁶.

When comparing the American system with the Brazilian, it is possible arguing that in the United States, the civil insolvency norms allow the system as a whole to control itself. Bankers, as credit granters, include in the risk speculation the possible losses of money related to insolvent borrowers. In Brazil, however, these possible losses are not taken in consideration, since there is no normative support for the lack of accomplishment of credit contracts and other debt obligations. In this sense, a bank in the U.S. would, as a creditor, behave itself in a totally different manner, than in Brazil. Depending on the existence or lack of civil solvency previsions and on the efficiency and real use of these, a bank will opt for

³⁹ The treatment of over-indebtedness in Brazil counts with a timid, but increasing, net of governmental institutions. The first project created was in the State of Rio Grande do Sul: it intends to guide the domestic budget and mediate debts negotiation with creditors. Further, there is a specialized Center for Defense of Over-indebted Consumers coordinated by public defenders in Rio de Janeiro. More information available at <http://www.portaldpge.rj.gov.br/nudecon/index.php?pagina=cdis>.

⁴⁰ LIMA, Clarissa; BERTONCELLO, Karen; and DALL'AGNOL, Maria. *Apud.* MELLO, Flávio Citro Vieira de. *Op. Cit.*, p. 19.

⁴¹ *Idem.*

⁴² Art. 649 of the Civil Procedure Code.

⁴³ Art. 43, p. 1º, of the Law 8.078/90 (Consumer Defense Code).

⁴⁴ Art. 42, p. único and art. 71, of the Consumer Defense Code.

⁴⁵ Law 10.820/2003.

⁴⁶ MELLO, Flávio Citro Vieira de. *Op. Cit.*, p. 24.

lending more or less and assuming the risk of non-payers. Basically, the possibility of a huge group of non-payers is considered by an American bank while calculating the risk of credit borrowing. This possibility is neglected in Brazil, because the insolvency procedures are not commonly used (except for extraordinary cases, as interdiction when a particular manager would be chosen for administrating one's debts, rights and goods) and do not predict debt relief and beneficial payment plans. In other words, in the banker's perspective the risk of not receiving the borrowed amount of money in the future varies. This situation may explain the size of bank net interest spread in Brazil.

V. Behavioral Law and Economics Biases and Consumer Behavior

The classic Economics is based on the concept of rationality. Basically, a human being is rational because he is able of deciding according to an order of preferences. However, behavioral scientists have already revealed evidence of cognitive illusions (“biases”) and mental shortcuts (“heuristics”)⁴⁷, which challenge the classic economical perspective. Even so, it is important to note that behaviorists do not claim that people act irrationally. Rather, they argue that “people act in ways that systematically and predictably diverge from the ‘rational choice’ model of traditional economic analysis”⁴⁸.

Consumers’ over-indebtedness can be analyzed considering these biases and heuristics. One of them is known as the “**overconfidence bias**”, according to which individuals tend to be overoptimistic and confident regarding their own susceptibility to risk.⁴⁹ In other word, consumers tend to believe that their financial situation will get better, despite of the credit purchased and the real risk of over-indebtedness.⁵⁰ Even more informed people, and, consequently, more aware of the economical and financial results of their actions, tend to be overconfident while analyzing their susceptibility to risk. This point suggests that **only** financial educating programs may not be successful in regulating the credit access. Nevertheless, this idea is not conclusive since it depends on many others variables.

Behavioral economists highlight that individuals “might respond to hot states in suboptimal ways”⁵¹ for many reasons. With regard to consumers, these find themselves constantly forced to make decisions according to heat-of-the-moment impulses. Exaggerated propaganda and social pressures tend to intensify such decision making process impulses. One explanation for that relates to the fact that in hot states people tend to overestimate how long theses states will last and how irreversible their decisions might be.

Another key concept in the behavioral theory analysis is the **availability heuristic**. According to this, individuals tend to estimate the likelihood of a future event based on how often similar events happen in the present.⁵² As a consequence, if consumers have not been exposed to financial problems in the recent past, they will not precisely estimate the probability of a future personal crisis. The opposite is also true. If someone is constantly in touch with certain events – for instance, because it is daily in the media, one will overestimate the likelihood of a similar future event. The fact is that “[f]or most consumers, serious incidents of over-indebtedness lack ‘availability’, so consumers understandably underestimate the risk of their

⁴⁷ KILBORN, Jason J. Behavioral Economics, overindebtedness and comparative consumer bankruptcy: searching for causes and evaluating solutions. *Emory Bankruptcy Developments Journal*, Vol. 22, p. 17.

⁴⁸ *Ibid.* p. 17.

⁴⁹ *Ibid.* p. 18.

⁵⁰ According to Jason J. Kilborn, “Lendol Calder explains, as U.S. consumers after World War II took on more and more debt ‘liv[ing] beyond their income but not beyond their credit,’ they palliated their anxiety with ‘the optimistic conviction that... we’ll make it somehow. Thing will always get better – maybe a lot better.’”

⁵¹ CAMERER, Colin; ISSACHAROFF, Samuel; LOEWENSTEIN, George; O’DONOGHUE, Ted; and RABIN, Matthew. *Regulation for Conservatives: Behavioral Economics and the Case for “Asymmetric Paternalism”*. *University of Pennsylvania Law Review*, Vol. 151. p. 1238.

⁵² KILBORN, Jason J..*Op. cit.*, p. 21.

own overborrowing”⁵³. This finding may suggest that financial education and information may be important to control over-indebtedness, because they represent a way of turning personal financial crisis more real for consumers, even if they do not live them currently. However, it is important to identify that the availability heuristic dialogues with the overconfidence in the sense that even if consumers have been exposed to current liquidity crisis, they may overweigh their future paying skills.

Another bias is called “**hyperbolic discounting**”, which means that often immediate costs and benefits are overvalued while delayed ones are undervalued. More often, present benefits and gratification tend to be highly overvalued, while future burdens and cost are discounted⁵⁴. Thereby, consumers might prefer using their overdraft banking services, underestimating the following real future cost resulted from it. In this sense, when deciding between saving for later and buying on credit (borrowing), hyperbolic discounting explains why the second option is mainly chosen. With regard to over-indebtedness regulations, hyperbolic discounting suggests that there is no direct relation between longer payment plans and the efficiency of discouraging overborrowing. Nevertheless, they may be less effective if consumers do not face them as fair ones⁵⁵. Recognizing this, the German parliament decided in 2001 to reduce the period between filing a procedure and the relief itself. As a consequence, German debtors are forced to pay with non-exempt income for no longer than six years⁵⁶. The positive aspect of this is that when the effects of hyperbolic discount are reduced, the educational potential of a shorter, but more efficient, paying period increases⁵⁷.

It may be argued that abandoning these biases may be extremely difficult, not to say impossible, in a way that the idea of curing over-indebtedness or totally preventing it should be overcome⁵⁸. Treating it would be, in this sense, a better available solution, while focusing in *ex ante* regulation, such as information policy, would be less effective in avoiding over-indebtedness. Although consumer financial education is important, “[b]ehavioral economics suggests, however, we ought not to expect too much from passive ‘debtor education’ as a core part of consumer over-indebtedness treatment”⁵⁹. This may possibly mean that an over-indebtedness regulation shall generate incentives for the creditor to better inform the debtors of the risks of the credit contract and to accurately choose the potential debtors, considering their possible future payment means. However, it is also worth noting that a relief system can be thought not only in terms of treating over-indebtedness situations, but also of preventing it as possible⁶⁰. Behaviors of consumer – debtors and potential debtors – may be changed according to the information available. In this sense, a bankruptcy system is also able of

⁵³ *Ibid.*, p. 22.

⁵⁴ *Ibid.*, p. 21.

⁵⁵ *Ibid.*, 37.

⁵⁶ *Idem.*

⁵⁷ *Ibid.*, 41.

⁵⁸ *Ibid.*, p. 23. According to Kilborn, “the revelations of behavioral economics not only suggest consumers labor under a variety of powerful biases, but ‘debiasing’ is difficult if not impossible.”

⁵⁹ *Ibid.*, p. 24.

⁶⁰ *Ibid.*, p. 25. According to Dickerson, “if the risks of overborrowing can be made more frequent, recent, or salient for potential debtors, that information might at the margins influence the credit behavior of potential victims of overindebtedness.” *Ibid.*, p. 26.

intensively publicizing the risks of over-indebtedness, making it more available and educating over-indebted consumers for the future. The recurrence rate of over-indebted consumers is a possible measure for defining if this goal is being achieved or not.

When analyzing the American bankruptcy system through these biases, Kilborn argues that chapter 7 approach does not allow information availability concerning potential risks and costs of over-borrowing⁶¹. Instead of this, the system represents an easy way out of debt and consumers absorbing this information tend to discount even more the potential future costs of purchasing credit in an excessive way. The European systems, on the other hand, are more prone to influence consumer behavior. In general, they demand debtors to attempt to draw a plan for payment in order to reserve future income for some years⁶². This helps tuning the cost of over-indebtedness more salient⁶³, differently from what happens in the U.S.

Another important aspect related to consumer behavior refers to the concept of fairness produced by the system. Behavioral science points that people present “**bounded self-interest**” in their interaction with others, *i.e.*, people are prone to give up potential benefits and sacrifice gains if this is deemed fair.⁶⁴ For instance, if in a certain community paying debts is understood as fair, a system that does allow individuals to evade obligations is viewed as unfair. People tend to act against self-interest not only to help those who act correctly, but also to punish the ones that did not. In this sense, if consumers understand that the system imposes unfair payment plans, they might not get the credit in the first place, even if this means not starting a new business or having huge gains. The sense of fairness in balancing costs and benefits is always present. As a consequence, if a system asks debtors to exaggeratedly divert of their income to creditors to the extent of not meeting basic needs, it will be seen as unfair.

It is relevant to perceive, however, that considering all of the biases pointed out by behaviorists may not be enough, or even totally desirable, for delineating the best way regulators should act. Mainly, because “the general truth is in fact not simple and perhaps not even excessively optimistic”⁶⁵. In the case of over-optimism, for instance, borrowers might prefer payday markets instead of credit card debts even knowing that the interest rates of the first one are incredibly higher.⁶⁶ When using lower priced credit forms, consumers may think that the potential of the indebtedness growing to a large amount is bigger, as is the case of more open-ended credit card indebtedness. This is mostly not considered when over-optimism bias is analyzed. This means, that behind biases, more complicated thoughts and attitudes may be hidden, which make the regulator’s job even more difficult.

⁶¹ *Ibid.*, p. 27.

⁶² *Ibid.*, p. 28.

⁶³ *Idem.*

⁶⁴ *Ibid.*, p. 30.

⁶⁵ MANN, Ronald. Nudging from Debt: the Role of Behavioral Economics in Regulation. *Lydian Journal*. January 2011. p. 5.

⁶⁶ *Idem.*

Even so, considering these biases – although they do not point to a final solution, allows regulators better understanding consumer behavior and delineating better ways of dealing with over-indebtedness. Still, other aspects related to regulation shall also be considered.

VI. Aspects related to Over-indebtedness Regulation

In order to deal with the over-indebtedness problem, many economical streams may be followed. Depending on the chosen one, different conclusions are reached. Some defend a paternalistic regulation, which involves three main features: it interferes with subjects' freedom; it comes primarily out of benevolence toward these subjects and does not depend on the consent of the subject⁶⁷. The advantages of such a way of regulating have been questioned, since "paternalism prevents people from behaving in their own best interests, [it] may prove costly"⁶⁸. As an alternative, asymmetric paternalism is suggested by scholars as a way of avoiding the harms resulted from paternalism, while dealing with the rationality, perfect competition and information problems not previewed by classic economics.

According to asymmetric paternalism premises, consumer can be divided into two different types: boundedly rational and fully rational ones. A policy is considered asymmetrically paternalist if it creates large benefits for the boundedly rational consumers, without imposing harms on the fully rational ones⁶⁹. One of the existing asymmetric paternalistic regulations involves information disclosure: the provision of information in disclosure legislation⁷⁰, which intends to allow the comparison of credit terms by consumers and to protect them from unfair lending practices. Such benefits are obtained in no costly way for informed consumers and creditors.

Another possible regulation attempts to avoid "hot" states decision (mentioned in Section V) to be taken by consumers. Cooling-off periods, responsible for delaying consumers' decision, are a way of avoiding decisions that are costly or impossible to reverse. As a rule, cooling-off periods do not represent a high cost for rational individuals and may change decisions taken by those mostly affected by the heat of the moment (boundedly rational consumers). Moreover, two different forms can be adopted: consumers are forced to delay action and decision until after a certain period or immediate decision is allowed but it may be reversed during the cooling-off period⁷¹. Still, another advantage of this provision is that it does not incentivize sellers to incite consumers to buy and to psychologically agitate them. On the other hand, rational and lasting arguments would have to be used in order to convince consumers to purchase goods and services.

Also other relevant aspects should be considered, while defining the best regulation form for preventing or repressing over-indebtedness. It is relevant noting that counseling, as part of an information policy, although not a main alternative should be considered as one of the tools for dealing with the issue. However, empirical data show that a simple counseling procedure should not be implemented solely, but together with other regulating rules. In this

⁶⁷ CSERNE, Péter. *Paternalism – methodological problems of an economic analysis*. Available at: http://works.bepress.com/peter_cserne/47. p. 1.

⁶⁸ CAMERER, Colin; ISSACHAROFF, Samuel; LOEWENSTEIN, George; O'DONOGHUE, Ted; and RABIN, Matthew. *Regulation for Conservatives: Behavioral Economics and the Case for "Asymmetric Paternalism"*. University of Pennsylvania Law Review, Vol. 151. p. 1211.

⁶⁹ CAMERER, Colin; ISSACHAROFF, Samuel; LOEWENSTEIN, George; O'DONOGHUE, Ted; and RABIN, Matthew. *Op. cit.* p. 1219.

⁷⁰ *Ibid.*, p. 1232.

⁷¹ *Ibid.*, p. 1240.

sense, policymakers should avoid adopting measures, which simply increases disclosures and information that consumers access before credit transactions⁷². American consumers, who received counseling, still tend to use credit excessively, when exposed to aggressive advertising of lending organizations.⁷³ Over-optimism is a bias that helps us understanding the reasons for that. As already explained, individuals tend to highly value current events and undervalue future ones.

In addition, it is relevant that neither creditors, who loaned recklessly, nor debtor who borrowed recklessly should be solely blamed for over-indebted situations. Policymakers should consider why creditors and debtors engage in specific behaviors and, therefore, the understanding of behavioral economics biases is useful. Getting to know some premises, such as that it is profitable for credit card issuers to target students since they are commonly in debt and their future income tends to increase⁷⁴, is a great step in order to delineate an applicable efficient regulation. Another example relates to the fact that it is also profitable negotiating credit with naïve or desperate consumers, who tend to pay higher interest fees.

In order to design the model mostly adapted to Brazilian features, existent ones shall be considered. One of them is the ‘fresh start policy’, which treats over-indebtedness as a risk inherent to credit development and access. The debtors’ goods are sold in order to pay for the possible bills, while the rest of these are forgiven⁷⁵. On the other hand, a ‘reeducation system’ is based on the idea that the consumer failed and needs to be reeducated. As a consequence, he has to pay his debt with his current assets and will necessarily compromise his future revenue⁷⁶.

Furthermore, extrajudicial and judicial negotiating procedures shall be considered. For some, it is desirable that the Court works as a second instance (not as the main one), mainly because pre-negotiating procedures may be more efficient for healing over-indebtedness⁷⁷. One of the Brazilian examples of extrajudicial negotiations is the Consumer Defense Center, which has a specific department working on over-indebtedness (NUDECON). It basically aims to solve over-indebted consumer issues without activating the Judiciary, through creditor negotiations. However, a new project of law is now being evaluated by one of the Houses of the Congress, aiming to solve over-indebtedness problem in the judicial instances, which differs from the treatment developed by NUDECON. If on the other hand, extrajudicial means are adopted for treating this core issue, the already existent administrative institutions shall be used. In Brazil, there is already a wide net of State’s organs of Consumer Defense, nationally coordinated by the Ministry of Justice (the Procons), which may have a really important rule in the over-indebtedness treatment.

⁷² DICKERSON, A. Mechele. *Op. cit.* p. 155.

⁷³ *Ibid.* p. 156.

⁷⁴ U.S. college students are a specific target of credit card issuers, because of these reasons. DICKERSON, A. Mechele. *Op. cit.* p. 154.

⁷⁵ MELLO, Flávio Citro Vieira de. *Op. Cit.*, p. 27.

⁷⁶ *Idem.*

⁷⁷ *Idem.* p. 28.

VII. Concluding Remarks

This article has just reviewed a potpourri of paradoxes related to over-indebtedness and has found multiple path to deal with this problem. The solution may be come from the simple definition of what over-indebtedness means or from the type – or group – of regulation to be adopted. Nevertheless, further regulatory developments will deal with the core question: if regulation is needed, should it be *ex ante* prohibitions, *ex post* liability rules, or a mixture of both? Foreign regulation aspects should be used as example and if necessary adapted to Brazilian features.