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PRESS RELEASES

Can Individual Over-indebtedness Be Prevented by Limiting Current Account Overdrafts in Croatia?

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The minister of finance on February 19th 2013 announced the Government's intention to prevent excessive borrowing by citizens in the form of huge current account overdrafts[1]. Can such good intentions really come true and what would be their expected effects be?

Household indebtedness is a serious private and social problem, especially from the perspective of social exclusion. Should over-indebted households not be able to meet their liabilities due to altered macroeconomic conditions (e.g. an interest rate hike, unemployment growth or diminishing income), this might lead to a financial crisis.

According to a CNB analysis,[2] household deleveraging accelerated during 2012, reducing household debt below 40% of GDP by the end of September. The decrease was primarily seen in exposure to banks (-0.8% of GDP-a), whereas household debt to other financial intermediaries (4% of total debt) remained relatively stable. At the annual level, total household debt dropped by 2% (1.5%, excluding the effects of a slight kuna exchange rate appreciation in the third quarter). Total amount of newly granted loans stagnated for almost two years, with only slight seasonal fluctuations, while the repayment of existing loans continued to be relatively stable. Consequently, total household debt declined effectively from 2009 to mid-2012, at an average annual rate slightly below one percentage point. Despite the adverse macroeconomic environment, households continued to save, but the deposit growth was somewhat slower than in the previous years. Household deposits with banks, accounting for the largest share in total liquid financial assets of households, continued to grow till September 2012, significantly improving the ratio between debt and the aforementioned financial asset categories.

Despite these movements, the minister of finance announced the Government's intention to impose a limit on citizens' borrowing in the form of excessive current account overdrafts. He emphasized that these measures would be to the citizens' benefit, as they would have to transform excessive overdrafts to ordinary lower-interest-rate consumer loans within one year.

In an interview to the *Novi list*[3] the CNB Governor explains that the Ministry of Finance, being the proposer of the Consumer Crediting Act, has a right to such an initiative. From the prudentiality point of view, such a proposal makes sense, because an overdraft in the amount of three monthly wages can hardly be considered as overdraft, but rather as a consumer credit at the highest interest rate. A client

[1] Government of the RC, 2013. *News and Announcements,* February 19, 2013.
[2] CNB, 2012. *Financial Stability,* No. 10, December 2012.
[3] Dragojević Mijatović, A. and Vujčić, B., 2013. "Nije lako Slavku Liniću potrošače štititi od njih samih" (It is not easy for Slavko Linić to protect consumers from themselves), *Novi list,* February 22, 2013.

is gradually lured into a trap of taking overdrafts with an end-of period debt that he/she may not be able to repay. However, this facility is very popular with both banks, which consider it as a profitable product, and consumers, who are accustomed to such simple, although expensive loans, except in cases when their unauthorised overdrafts become so high that they end up on the blacklist.

The current account overdraft is a banking facility offering flexibility in the use of one's own financial resources without unnecessary paperwork. Overdraft users do not have to strictly adjust their current account inflows and outflows in the short run and are spared from lengthy loan obtaining procedures. The problems with loans are not only the complicated, expensive and lengthy granting procedures, but also the fact that they must be repaid in regular instalments within a determined period. Current account overdrafts represent a relatively simple and the most accessible way of citizen "financing", enabling them to "automatically" borrow a certain amount, which they would probably not do so easily if they had to file a loan application. Moreover, in an environment of economic and labour market recession, the use of payment cards and bank overdraft facilities enables citizens to balance their monthly household budgets, with more or less difficulty and at more or less self-sacrifice. In contrast to overdrafts that can be repaid as early as the next month or at the client's convenience, an early loan repayment involves the filing of an appropriate application and payment of loan prepayment charges, while in a month or two everything may start a new.

The Croatian Banking Association (HUB) and its member banks have long warned of current account overdraft as one of the most expensive types of loans. It should only be used for bridging monthly household budget gaps until the salary or another income is paid into the client's account. The financial literacy of citizens seems to be rather poor, as citizens are inadequately informed about the rights and obligations in dealing with banks and other financial institutions. Within its Personal Finance Management project (free workshops for citizens launched in 2006 and still available on its website)[4], the HUB and its member banks have informed the participants that it is generally more favourable to take on some other type of credit and to gradually repay a "persistent" overdraft. In other words, the swap of current account overdrafts for credit already exists, but, for the above mentioned reasons, citizens are not inclined to this option.

Furthermore, lower-interest-rate loans might lead to further deleveraging and reduction of disposable income within the maturity of such loans after a year or two, and to an increase in disposable income at the end of that period. Everything depends on products to be offered by banks, because they would obviously replace the current account overdraft facility by a similar product. The possible mandatory conversion of current account overdrafts into loans will almost certainly cause no material changes, as general-purpose cash loans are also expensive and mean considerably more paper work and costs (notary public and other fees) for clients, as well as a waste of time.

Now, if citizens are obliged to reduce their overdrafts by two monthly salaries within a one-year period, they must somehow provide the necessary funds (which they actually do not have). They probably have three options to do so:

- They can take on a general-purpose loan (but only if they are creditworthy) in order to pay back the overdraft, and thus again incur debt. So, there is little benefit for them, except in the form of slightly lower interest rates (by 1-3 percentage points in nominal terms), but more paperwork, as mentioned before.
- They will have to repay the overdrafts from regular income, which again means more belt-tightening. This will, of course, result in spending cuts and/or less VAT revenues in the state treasury. Due to reduced bank profits, government revenues from corporate income tax will also shrink.
- There are also citizens who are neither capable of repaying their overdrafts nor creditworthy. Banks can reschedule their debt, extend the debt repayment periods, reduce their monthly instalments or annuities, etc. Another possibility is to attempt to collect debt or seize property. Both models imply higher costs for banks in the form of provisions and value adjustments. These costs affect the banks' income statements by reducing profit and, consequently, influencing budget revenue. Minor banks, balancing on the edge of capital adequacy might get into difficulties, which could trigger a need for recapitalisation, merger or even bankruptcy of

[4] http://www.hub.hr.

such banks (the latter being less likely). Finally, credit-unworthy citizens who are bound to reduce their current account overdrafts would be forced to seek illegal loans on the black financial markets and thus contribute to negative experiences and sad stories of victims of loansharking.

According to the regulations and achieved risk management standards, banks are expected to be able to assess their credit risks. Clients should have the freedom and ability to assess the level of their needs and the ways of financing them. So far, clients have been in the position to determine the amounts of their authorised overdrafts, by requesting the bank to reduce these amounts to a desired level. There are a number of reasons why this banking facility should be regulated. However, reducing the authorised overdraft directly impinges on the freedom of citizens to take economic decisions in a market economy. This only contributes to the already strong paternalism in the Croatian society, where the government "knows what's better for it's citizens than the citizens themselves."

If the purpose of the proposed changes is the citizens' welfare, there are no obvious reasons why they should be legally prescribed, as this threatens the clients' freedom to contract and choose banking products, and affects diversity of supply and, consequently, the business policies of banks. In an extreme case, the next move in this direction might be that those who are "in the unauthorised red" for several consecutive months could be deprived of legal capacity on grounds that they are unable to manage their own funds and would be assigned tutors by the state to manage their salaries on their behalf.

Despite the undoubtedly good intentions of the proposer, the said decision is unlikely to bring any substantial benefit, at least in the short run. Indeed, it is more likely to cause harm. In the long run, of course, over-indebtedness should be reduced. To this effect, by improving financial literacy of citizens, stepping up regulation and encouraging market competition among banks, the quality and diversity of credit facilities can be increased and interest rates successfully reduced. This would facilitate the access to and lower the prices of financial services, especially loans, for citizens, enabling them to freely choose a combination of banking services that would be the most favourable, cost-effective and sustainable in the long run.