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Assessment of the Debt Relief Program and Need for Preemptive Credit Counseling

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Assessment of the Debt Relief Program and Need for Preemptive Credit Counseling

Yoonhae OH, Fellow at KDI

The number of filings for the debt relief program, especially rehabilitation personal bankruptcy of the court, has risen recently. Preemptive credit counseling is needed to help troubled households find solutions that best fit their needs in order to improve the structure of their debt and suppress a further increase of defaults. To this end, accessibility and neutrality of credit counseling should be improved.

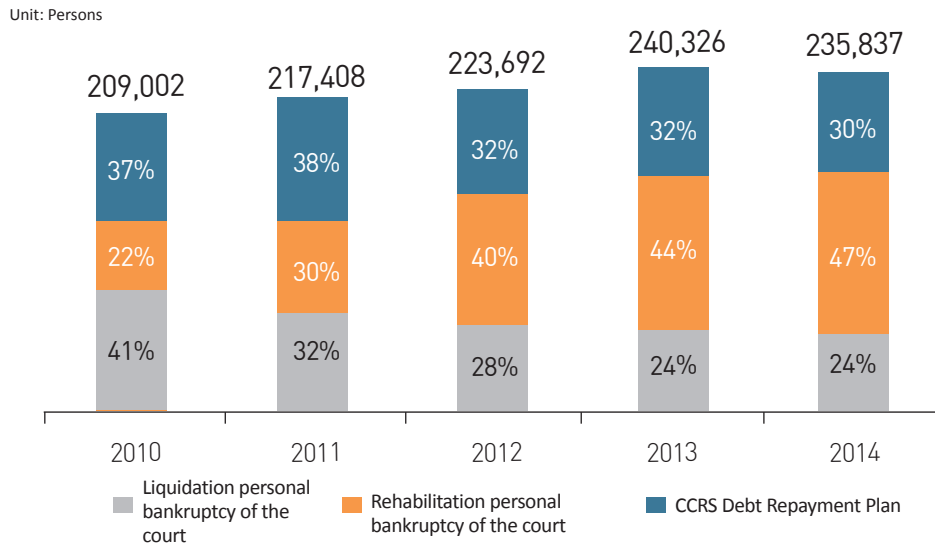
I. Introduction

Rising household debt and prolonged low economic growth have produced a swelling number of debt defaults. Figure 1 shows the rising number of debtors seeking debt relief since 2010. The trend is expected to persist for the time being, raising the urgency to rescue debtors and thus slow the pace of defaults.

Effective rescue of debtors and prevention of further defaults is urgently needed.

Against this backdrop, this study conducts an empirical analysis to assess the methods for utilizing the current debt relief program in Korea and emphasizes the necessity for preemptive credit counseling, which helps prevent exacerbation of borrowers' debt load and ensures more efficient use of debt relief choices.

[Figure 1] Annual filings for debt relief programs



Source: Court of Korea monthly statistics and the Credit Counseling and Recovery Service homepage

II . Debt Relief Programs in Korea

1. Liquidation: Court-mediated liquidating personal bankruptcy

Liquidation personal bankruptcy of the court first appeared in Korea in 1997. It refers to court proceedings for final liquidation of debts to establish bankruptcy status and release from any remaining liability. In the bankruptcy stage, all of the non-exempt assets of borrowers are liquidated and the creditors are paid. In the discharge stage, borrowers are released from outstanding debt and disadvantages resulting from bankruptcy status are lifted. Unlike debt restructuring, debtors with no income can use liquidation personal bankruptcy of the court and their future earnings belong to the debtors.

Liquidation personal bankruptcy of the court refers to court proceedings for final liquidation of debt.

2. Debt Modification: Court and CCRS

In debt modification programs borrowers pay their debt with future earnings by rescheduling the debt or reducing the principal. There are two primary channels in Korea for modifying troubled individual debt – court mediated rehabilitation bankruptcy and a debt repayment plan through the Credit Counseling and Recovery Service (CCRS), the nation’s biggest credit counseling provider. Both focus on non-secured debt.

Debt restructuring allows borrowers to pay their debt with future earnings by rescheduling the debt or reducing the principal.

Rehabilitation personal bankruptcy was introduced in Korea in 2004. The court orders individuals to surrender all of their earnings, excluding predetermined minimum living costs for a specific period of time regardless of the total amount of their debt. The repayment period is typically five years in most cases, and the remaining non-secured debts are

discharged. Secured loans, including home equity loans, are not subject to modification.

The CCRS Debt Repayment Plan started as a private agreement among financial institutions in 2002 when the court's rehabilitation personal bankruptcy was not yet available. In the CCRS Debt Repayment Plan, the debt owed to multiple financial institutions is consolidated, and debt principal is reduced to an amount that varies with the type of loan. Microcredit, help in job searching and other auxiliary services are also provided. Home equity loans, rescheduled payment periods and reduced interest rates may be provided with the consent of the majority of creditors.¹⁾ Details of each program are shown in Appendix 1 at the end of this paper.

3. Discussion on the structure of debt relief programs

The debt relief program functions as a form of social insurance in that it provides incentives to heavily-indebted individuals to be productive, thereby mitigating social risk factors. On the other hand, if debt relief programs are too relaxed, debtors may be tempted not to honor their obligations. It is thus important to seek an institutional balance between protecting creditors' rights and debtors' rehabilitation.

However, debt relief program in Korea expose obstacles to effectiveness. Borrowers tend to fall into a vicious circle of paying debt by taking on more expensive credit. As for court proceedings, there is disagreement about broader coverage for debt discharge. Some insist that revisions are needed to lower the burden on borrowers. Others point to possible abuses stemming from moral hazards. Meanwhile, filings tend to be concentrated in one category as illustrated in Figure 1: liquidation personal bankruptcy of the court was debtors' program of choice in 2010 while it was rehabilitation in 2014.

Borrowers tend to fall into a vicious circle of paying debt with more expensive credit.

Against this backdrop, this study examined the factors affecting filings for debt relief programs and the characteristics of users. The findings were used to emphasize the need to introduce preemptive credit counseling services to prevent worsening of debt structure and provide debtors with unbiased fair advice that consider the characteristics of individual circumstances.

1) In the CCRS Debt Repayment Plan, restructuring of home equity loans was implemented only after the creditor consent criteria was loosened from 2/3 to 1/2 in June 2013.

<Table 1> Debt structure of those in rehabilitation personal bankruptcy of the court in Seoul

Classification		Filings in 2010	Filings in 2012
Average debt principal		58.82 mil. won	70.64 mil. won
Creditor share of debtors	Credit card companies	68 %	78 %
	Lending corp.	53 %	75 %
	Savings banks	46 %	56 %

Source: An excerpt from Kim, Duol et al. which analyzed a sample of 200 debtors by year (2013, p111).

<Table 2> Effects of regional household debt structure on debt relief program filings (panel regression analysis)

	Individuals seeking relief	Debtors in rehabilitation
Household loans/ deposits at financial institutions	+	+
Share of household debt from savings banks to other non-bank financial institutions	.	+

Note: "+" denotes a positive effect. Liability data were drawn from a quarter earlier. For details, see Oh, Yoonhae (2014, pp26-29).

III . Assessment of Debt Relief Program Options and the Need for Preemptive Credit Counseling

1. Need to improve debt structure through credit management education

A. Worsening household debt structure

A recent sample survey found worsening household debt in Korea. Table 1, based on debtors in rehabilitation personal bankruptcy of the court in Seoul, shows the average amount of debt principal increased significantly from 58.82 million won in 2010 to 70.64 million won in 2012. Also, confirmed was a larger share of debtors who owe credit card companies, lending corporations and savings banks, all of which quote much higher interest rates.

As illustrated in Figure 1, the rising percentage of debtors resorting to court modification instead of the CCRS Debt Repayment Plan also suggests that the debt load already is souring when debt relief program is sought. Rehabilitation personal bankruptcy of the court is more appropriate for debtors in worsening circumstances because the CCRS Debt Repayment Plan limits the reduction rate of principal and do not cover private lending or loans by certain lending corporations.

Table 2, based on a panel data analysis, confirms growth in household debt against deposits in a region translates into an increased share of local individuals filing for debt relief programs as well as debtors turning to modification compared to those in debt repayment plan of the CCRS. In addition, the ratio of debtors seeking modification to those in the CCRS Debt Repayment Plan rises as with the higher share of borrowers who owe savings banks, among non-bank financial institutions. which generally have higher interest rates. All of these factors link the recent surge in filings for rehabilitation personal bankruptcy of the court to deteriorating household debt structure.

The average amount of debt principal increased significantly. So did the share of debtors who owe credit card companies, lending corporations and savings banks, all of which quote much higher interest rates.

<Table 3> Vulnerability of households in default risk

Classification	Share
Used credit card cash advances to pay debt	68.5 %
Failed to seek debt relief program due to lack of awareness	11.0 %

Note: The above are results from questions to households who experienced default risks during 1997 to 2010.

Source: Second survey on "2011 Welfare Needs," the Korea Institute for Health and Social Affairs.

<Table 4> Reason for indebtedness and average income of debtors seeking debt modification in Seoul

Year of filing for debt restructuring: 2012	Rehabilitation personal bankruptcy of the court	CCRS Debt Repayment Plan
Share of individuals citing lack of income for indebtedness	89 %	55 %
Average monthly income	1.54 mil. won	1.20 mil. won

Source: Data on Rehabilitation personal bankruptcy of the court were drawn from Kim, Duol et al. which analyzed a sample of 200 debtors (2013, p116). Data on the CCRS Debt Repayment Plan were compiled by the author based on the CCRS sample of 2,067 debtors.

B. Debt management missteps

The worsening debt structure is attributable not only to the economic downturn but to inappropriate debt management by borrowers. Those struggling to pay their debts should restructure their debt and modify their spending habits, and seek debt relief program at an opportune time. In Korea, however, debtors tend to make matters worse by taking on more expensive loans to pay off existing debts without seeking appropriate solutions.

Official data on individual defaults in Korea is scarce. Table 3 shows the results of a 2011 Ministry of Health and Welfare survey on the behavior of households that have defaulted since the 1997 Asia currency crisis. Among households, 68.5% said they attempted to pay off their debts with credit card cash advances and 11% said they did not seek any debt relief programs because they were unaware of any options. Similarly, a 2013 Statistics Korea's survey on household financial welfare found that 5.2% of indebted households hold loans to repay other loans. The results underscore the need to provide help for troubled debtors to resolve their financial problems at an appropriate time rather than leaving them with no option but to take out more loans to service debts. To this end, it is necessary to have borrowers at risk of default undergo credit counseling to learn how to manage their credit ratings, a practice seen in advanced countries.

Among households in default, 68.5% attempted to pay their debts with credit card cash advances and 11% were unaware of debt relief program options.

2. Need for fair advice based on individual circumstances

A. Need for varied debt relief program options

If court proceedings are the best solution for all debtors, other debt relief program options such as the CCRS Debt Repayment Plan would be useless. In reality, the most suitable debt relief program scheme depends on income, liability and reason for indebtedness.

Some debtors may need to change their spending habits or get help with finding welfare services. Table 4 shows that more than half of borrowers in modification or debt repayment in Seoul pointed to lack of income to make ends meet as their reason for

indebtedness. This implies that their spending habits need to be modified to avoid taking on more credit to pay for living costs, thereby slipping into a series of defaults.

As for debtors in rehabilitation personal bankruptcy of the court and debt repayment of the CCRS, they earned 1.54 million won and 1.2 million won per month, respectively, which was much lower than the 2.11 million won monthly earnings recorded in the 2012 Economically Active Population Survey.²⁾ The gap also indicates that a high percentage of debtors in default would need help in finding employment or access to welfare services to secure a stable source of income.

Certain debtors may favor the more flexible private restructuring through the CCRS Debt Repayment Plan over court proceedings. Repayment rates of and monthly repayment in debt restructuring in Seoul are illustrated in Table 5. It is natural that the average repayment rate (the total amount paid against the principal of non-secured loans) is higher in the CCRS Debt Repayment Plan than in rehabilitation personal bankruptcy of the court because the CCRS Debt Repayment Plan limits the principal reduction rate. Notably, the repayment rate is about the same between the CCRS and the court among borrowers of 20 million won or less, meaning that debt repayment would be a better choice for borrowers with a modest debt total, considering the fees (approx. 2 million won) and the lengthy, complex procedures involved in court proceedings. In addition, the average monthly repayment (monthly amount paid against monthly income) was smaller in the CCRS Debt Repayment Plan that offer longer periods for repayment.

Comparison of other features such as provision of microcredit and other auxiliary services, ban on loan collection from guarantors, and possibility of restructuring of home equity loans also shows the CCRS Debt Repayment Plan is more favorable for debtors than rehabilitation personal bankruptcy of the court.

Some debtors may favor more flexible private restructuring methods that the CCRS Debt Repayment Plan offers than court proceedings.

B. Limitations of services by legal agencies

The array and complexity of debt relief programs prompt many debtors to seek legal assistance to help decide the most suitable choice. Most borrowers simply peruse ads to find a legal advisor but there are no incentives for legal agencies to recommend anything but court proceedings, which would produce service fees from clients.

Figure 1 above showed a recent surge in the number of debtors filing for rehabilitation personal bankruptcy of the court. Some express concerns that the surge is partly due to ill-advised decision-making. The business tactics of legal agencies also have come into question, including the appropriateness of ads which declared, “Don’t pay your debts,” as

2) If liquidation personal bankruptcy of the court is considered, the average earnings of individuals in default would fall further because, unlike rehabilitation personal bankruptcy of the court or debt repayment filing for liquidation personal bankruptcy of the court does not require proof of stable income.

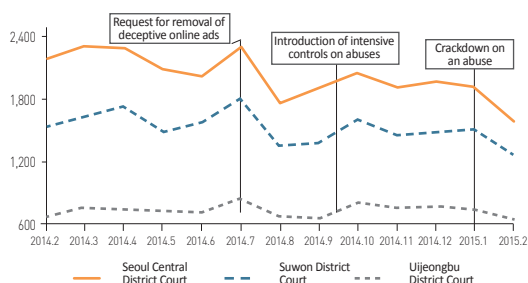
<Table 5> Repayment rates and amount in debt restructuring (Seoul)

Year of filing: 2012	Rehabilitation personal bankruptcy of the court	CCRS Debt Repayment Plan
Average repayment rate on 20 million won or less debt	73.6 %	78.6 %
Average repayment rate	53.5 %	80.1 %
Average monthly payment/monthly income	30.5 %	21.1 %

Note: The repayment rate is the total amount repaid against the principal of non-secured loans.

Source: /bid. Table 4.

[Figure 2] Monthly filings for rehabilitation personal bankruptcy of the court in the Seoul metropolitan area



Source: Court of Korea monthly statistics.

well as suspected illegal collusion with lending corporations.

To address the concerns, the CCRS in July 2014 requested Internet portals to refrain from allowing legal agency ads that encourage moral hazards. The Seoul Central District Court also made concerted efforts to control abusive rehabilitation personal bankruptcy from September 15, 2014, and uncovered some case in January 2015. Figure 2 shows a decline in rehabilitation personal bankruptcy of the court filings in the Seoul metropolitan area after these measures were applied. This indicates that not only is there a worsening of household debt, but legal agencies who lacked neutrality probably affected the increase of filings for rehabilitation personal bankruptcy of the court.

Therefore, it is necessary to expand unbiased credit counseling services that give an unrestricted presentation of options to debtors. Strict review of the court to decide debt discharge³⁾ can alleviate the possibility of debtor abuse of bankruptcy to take advantage of broader coverage for discharge.⁴⁾ Court reviews, however, would be not enough if debtors are inappropriately advised by legal agencies to file for court mediation. If debtors are provided with unbiased fair advice from credit counselors before they seek help from legal agencies, it would help considerably in preventing the abuse of court proceedings while also providing debtors with a diverse range of resolutions to help with their debt problems.

Although many debtors seek help from legal agencies, there are no incentives for the firms to recommend anything but court proceedings.

3) Since 2007, filings for liquidating personal bankruptcy of the court, which provides the broadest coverage for debt discharge, have soared. In response, courts began reviewing reasons for disapproval of discharge without creditors' claims, and in 2011, barred discharge of debts resulting from gambling or overspending. The rate of disapproval of discharge rose thereafter with the number of filings for liquidation personal bankruptcy of the court dropping (see Figure 1). Oh (2014) also found that the ratio of filings for rehabilitation personal bankruptcy of the court to those for liquidating personal bankruptcy of the court increased as the rate of disapproval of discharge went up at district courts.

4) In the meantime, there are also worries that debtors in dire need of liquidating personal bankruptcy could be reluctant to file for debt relief programs with their strict reviews. To resolve this, bankruptcy judges in different jurisdictions need to collaborate to narrow the regional gap in bankruptcy decisions while raising the predictability of the results of discharge.

<Table 6> Determinants of debt restructuring: CCRS Debt Repayment Plan cases (Logit analysis)

Determinants	Probability of dropouts from debt repayment plans
Share of lending corporations in total debts	+
Length of default (No. of months)	+

Note: Sample of 33,396 filings for debt repayment plan of CCRSs in 2007-2009 was analyzed. Dropout was checked as of July 2014. For details, see Oh (2015).

IV . Contents and Effects of Preemptive Credit Counseling

Credit counseling is effective in improving borrowers' debt structure. If borrowers receive debt management assistance before their debt structure deteriorates, they probably will be able to manage their debts successfully.

As discussed above, a more preemptive approach to credit counseling is needed to tackle Korean debtors' mistakes in credit management and prevent a further worsening of their debt load. Credit counseling in the UK and US provide useful references. In the UK in particular, counseling for less privileged classes is at the heart of the country's social welfare system (Suh[2012], p.4).

In the UK and US, credit counseling identifies the causes of credit issues by reviewing individual debtors' financial status and introduces debt restructuring options or financial education sessions (Suh[2012], p.2). Credit counseling is thus effective in improving borrowers' debt structure. Multiple empirical studies have found that counseling has a positive effect on debtors' ability to avoid default (Collins[2007]; etc.).

If borrowers receive debt management assistance before their debt structure deteriorates, they will more likely manage their debt successfully. Table 6 shows the findings of an analysis of the determinants of success/failure of debtors in the CCRS Debt Repayment Plan in 2007-2009. According to the analysis, the probability of dropout rises among borrowers who have a large share of debt with money lenders and those in default for a longer period of time. Therefore, if borrowers are advised in a timely manner and attempt debt repayment before their debt plight worsens, restructuring success is more certain.

Unbiased fair credit counseling can complement the management of debt relief program plans by presenting diverse means of debt management appropriate to individual cases.

In addition, credit counseling can reinforce debt relief program systems for more effective operation since it helps debtors identify the most appropriate solution to their needs. In most countries, including Korea, many worry about moral hazards among borrowers in debt relief program programs. In the case of the US, debtors seeking liquidation personal bankruptcy of the court have been required to attend credit counseling sessions since 2005, a move designed to reduce moral hazards. The National Foundation of Credit Counseling (NFCC), a representative US nonprofit financial counseling organization, introduces debtors to a variety of approaches, including education sessions on spending habits and consumption patterns, and access to welfare services. This proves that unbiased fair credit counseling can complement debt relief program systems by presenting diverse means of debt management appropriate to individual cases.

V . Tasks for Preemptive Credit Counseling Services

As shown above, preemptive credit counseling helps prevent worsening debt load and saves social costs to operate debt relief program systems. Also, if expanded credit counseling proves to be a deterrent to abusive uses of court debt relief program, distrust of debt relief program systems will be eased and the time to proceed with court procedures will be shortened.

Such positive functions of credit counseling, however, have yet to be fully realized in Korea. Some are even suspicious of the neutrality of the CCRS. Thus, it is critical to increase access to credit counseling, and reinforce the neutrality of the service.

1. Strengthened accessibility

Borrowers need to be encouraged to use credit counseling before their debt structure severely weakens to take advantage of the preventive function of the service. In 2013, US NFCC counselors guided modification of debt structure and spending habits to resolve financial problems for 38% of users. In Korea, borrowers turn to credit counseling only after their problems reach a critical stage, limiting the preventive function of credit counseling.⁵⁾

It is thus essential to broaden borrowers' access to credit counseling. An effective way would have financial institutions inform borrowers on how to get credit counseling when notifying them of defaults, as is done in the US. Linking receipt of credit counseling to extra benefits for low-income households when they turn to government subsidized microloans such as Sunshine Loan also needs to be considered because many borrowers with a low credit rating may need debt management or other welfare services rather than additional loans.

As in the US, requiring debtors to attend credit counseling sessions before seeking personal bankruptcy of the court would be effective in promoting credit counseling services. If mandatory counseling raises concerns over blocking access to court proceedings, a fast track to the court should be strengthened instead. In 2014, the Seoul Central District Court benefited borrowers who complete counseling courses provided by the CCRS and Seoul City's financial welfare centers by curtailing the time for paperwork. The average duration of time at each stage was shortened significantly with the introduction of the fast track approach as illustrated in Table 7. This indicates that promotion of the fast track will have a positive effect on credit counseling.

To facilitate credit counseling, it is critical to increase access to credit counseling and reinforce the neutrality of the service.

It is essential to increase borrowers' access to credit counseling through diverse means.

5) Credit management education is conducted for debtors approved for CCRS Debt Repayment Plan or provided by the CCRS in the form of on-site sessions.

<Table 7> Speed to liquidation personal bankruptcy of the court before and after fast track introduction

Stage	2013 (Feb. to Dec.) Pre-fast track introduction		2014 (Jan.-Sept.) Post-fast track introduction	
	Average time	No. of persons	Average time	No. of persons
Deciding bankruptcy after counseling	78 days	90	43 days	236
Deciding discharge after bankruptcy decision	274 days	82	85 days	120

Source: Compiled by the author based on the Seoul financial welfare center data.

2. Reinforced fairness

In countries where credit counseling is actively used, the neutrality of counselors is heavily emphasized to ensure fair and effective advice. The NFCC, for instance, collects counseling fees from users, commission from financial institutions, and donations to diversify its revenue base, thereby protecting its institutional neutrality.

In contrast, institutional infrastructure for credit counseling is weak in Korea. With the exception of financial welfare counseling centers operated by Seoul and Gyeonggi Province, most credit counseling is concentrated at the CCRS, which is simply used as a step to check the availability of the CCRS Debt Repayment Plan. As for financial resources, the CCRS largely depends on support from partner financial institutions except for a small counseling fee (50,000 won). Such a shaky revenue base prompts misgivings about the organization's neutrality.

Against this backdrop, the country's financial regulator plans to integrate the CCRS's debt management function and other policy finance programs for low-income households, including Smile microbank, into the Microfinance promotion agency.⁶⁾ The incorporation of Smile Loan, which is funded with deposits at dormant accounts and donations, will diversify the agency's sources of revenue while strengthening the public nature of the agency, thereby raising the institutional neutrality above that of the CCRS.

What matters at this point is assurance of "fair" counseling. In other words, counselors do not steer borrowers to specific programs for their own benefit or their organizations' profits when borrowers need court proceedings. To improve the fairness of counseling, counselors should clearly decide what is best suitable to troubled borrowers and lead them to appropriate court measures if necessary.

For the success of the Microfinance Promotion Agency, it is thus important to have counselors with expertise to decide which programs best fit the needs of individual borrowers. At the same time, the institutional base for credit counseling should

For the success of the Microfinance Promotion Agency, it is important to have expert counselors to decide which programs best fit the needs of individual borrowers.

6) The bill for establishment of the agency is pending at the National Assembly due to concerns over possible conflicts between the debt management function and microfinance for working-class households.

be expanded beyond the agency to incorporate local governments, social welfare organizations, and non-profit organizations.

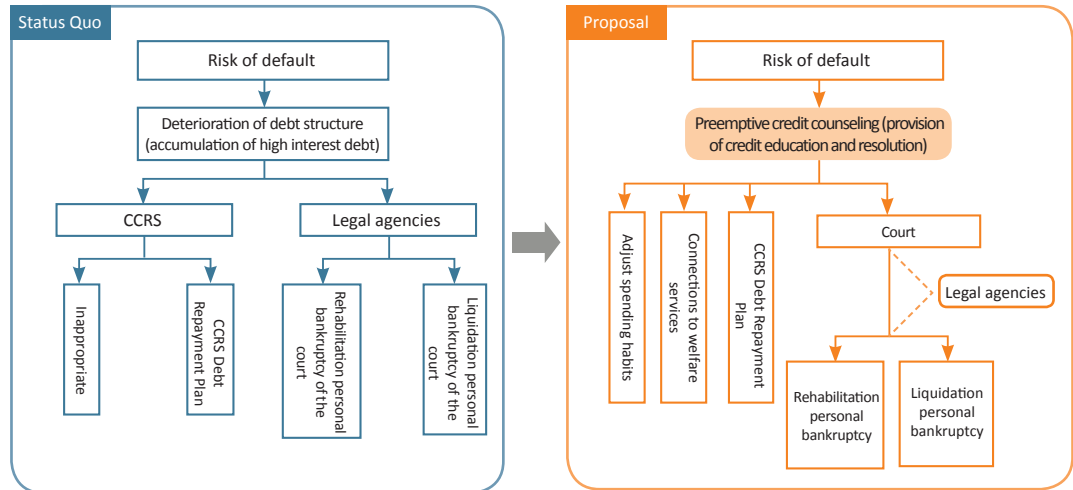
VI. Conclusion

Several regular public/private debt management programs have already been established in Korea. However, there are still issues over the effectiveness of the programs' operation; borrowers often fail to seek debt relief program before it is too late and suffer from worsening debt structure or struggle to decide which debt relief program option fits their need. This raises the necessity to increase the accessibility and neutrality of credit counseling services to tackle the operational issues of debt management.

For this, every stakeholder has a role to play; debtors should attempt to improve their debt structure, the CCRS needs to find ways to increase neutrality and strengthen access to credit counseling, and the courts have to expand the fast-track system to more regions to motivate borrowers to attend credit counseling, and regulate excessive marketing by legal agencies.

At present, there are discussions on ways to improve debt relief programs, including shortening the rehabilitation personal bankruptcy of the court period and limiting financial institutions' rights of exclusion applied to home equity loans. Close analysis of situations is a precondition for making right policy decisions. However, this has not happened in Korea due to a lack of data on the characteristics of debtors in default and other important aspects related with using the debt relief program system. Therefore, establishment of relevant database is urgently needed to effectively deal with the rise in the number of individuals in default and prepare efficient debt relief systems. ■

<Appendix 1> Utilizing Preemptive Credit Counseling



<Appendix 2> Debt Relief Programs in Korea

Classification	Public		Private
	Liquidation	Debt modification	
Programs	Liquidation personal bankruptcy of the court	Rehabilitation personal bankruptcy of the court	CCRS Debt Repayment Plan
Principal agent	Competent court of the applicants' residence		Credit Counseling and Recovery Service
Execution	First filing in 1997	Sept. 2004	Oct. 2002
Coverage	No limit (incl. private loans)		Debts overdue 3 months or longer at partner institutions
Ceiling	No limit	A total debt of 1.5 bil. won (0.5 bil. unsecured, 1 bil. secured) of individuals earning minimum wage or more	
Repayment period	Discharge after liquidation	Usually 5 yrs.	Unsecured: Up to 8 year (2-year grace period available) Secured: Less than 20 years (3-year deferment available)
Extent of restructuring	Debts subject to discharge (excl. taxes, fines, etc.)	Repayment with earnings, excl. living expenses for 5 yrs. (applicable if repayments exceed liquidation value. Secured loans are not covered)	Unsecured debt: Interest is reduced/exempted, principal is written off up to 50% Secured debt: Overdue interest is reduced/exempted
Guarantor	Collection on guarantor is allowed		Collection on guarantor is not allowed
Effectuation time	Statutory discharge is given when authorized	Statutory discharge is given when full repayment is made	Discharge is given when full repayment is made under a private agreement
Credit information	Default registration is cancelled when discharge is decided. Bankruptcy registration is cancelled after 5 years.	Default registration is cancelled when rehabilitation is authorized. Rehabilitation record is deleted after rehabilitation is completed.	Default registration is cancelled when workout support is finally decided. Record on using the workout program is deleted in the second year of repayment.
Others	Legal aid is available from the Korea Legal Aid Corporation.		Microfinance, employment support, and credit management education are available.

Note: Liquidation personal bankruptcy of the court, the final rescue mediated by the court, was institutionalized in 1962 when the Bankruptcy Act was legislated. However, the first filing was not made until 1997.

Source: Compiled by the author based on the One-Stop Finance for Low-income Households and CCRS websites.

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