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Corporate and Household Debt Distress in Latvia: Strengthening the Incentives for a Market-Based Approach to Debt Resolution

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Corporate and Household Debt Distress in Latvia: Strengthening the Incentives for Market-Based Approach to Debt Resolution

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Authorized for distribution by Anne-Marie Gulde-Wolf

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Abstract

This paper reviews Latvia's efforts to manage the increase in debt distress resulting from the unwinding of the 2000–07 credit boom and spillovers from the global financial crisis. The authorities have designed a strategy that strengthens incentives for marked-based debt resolution by improving the legal framework for credit enforcement, introducing tax incentives for debt write-downs, and strengthening financial sector supervision. These measures have started to yield results, but further steps are needed to speed up bankruptcy procedures and reduce credit enforcement costs. Latvia's experience with market-based debt resolution may provide insights on managing debt distress in other countries with limited fiscal resources.

JEL Classification Numbers: G21, K35

Keywords: Latvia, debt restructuring, insolvency law

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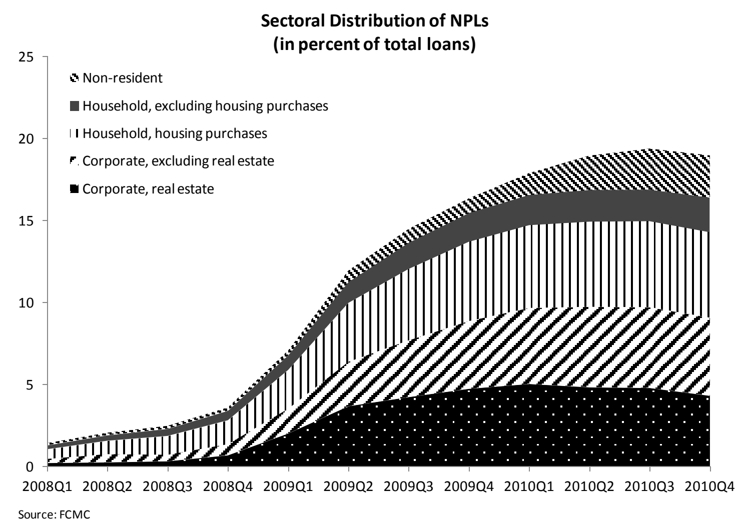
I. INTRODUCTION

Latvia's credit-fuelled boom in 2000–07 rapidly increased the non-financial private sector's (NFPS) debt burden. In common with many CEE countries, the indebtedness of Latvia's largely foreign currency-denominated NFPS debt—defined as the gross liabilities of the Latvian corporate and household sectors to domestic and external creditors—increased rapidly during the boom years in 2000–07. The main drivers of this increase in indebtedness were Latvia's transition towards a market-based economy, abundant liquidity, low interest rates—particularly on borrowing in foreign currency—and the free flow of capital and labor following Latvia's accession to the EU in 2004.

The unwinding of this credit boom led to a deep recession and a sharp increase in nonperforming loans (NPLs). GDP growth plummeted from double digits in 2007 to minus 18 percent in 2009—the deepest recession in the world at the time—wages and prices fell and unemployment increased to nearly 21 percent. NPLs—defined as loans overdue by more than 90 days—reached 19 percent of total loans at end-2010, up from 16 percent at end-2009 and some two percent at the onset of the crisis in mid-2008. Debt distress affects both the corporate and household sectors. NPLs on household mortgages account for nearly 30 percent of overall NPLs and have more than tripled since end-2008. In the corporate sector, debt distress is now affecting most sub-sectors after being initially contained to real estate related activity.[2]



Experience from other countries suggests that debt distress could weigh on medium-term growth. A debt overhang may constrain credit availability and constrain domestic demand, putting downward pressure on prices and increase the real indebtedness of borrowers, thereby increasing the risk of a debt-deflation spiral. A framework for addressing the high level of debt distress in Latvia is therefore a crucial component of any strategy to restore macroeconomic stability in the country.

[2] Regardless of sector, the majority of NPLs remain collateralized with real estate (real estate serves as collateral for 90 percent of loans to private persons and 70 percent of loans to corporates).

The purpose of this paper is to assess the framework for debt restructuring in Latvia, and to propose areas of improvement where needed. Our findings suggest that the authorities' efforts to strengthen market-based approaches to debt restructuring are beginning to yield results. In particular, the amendments to tax legislation and improvements to the insolvency regime, coupled with the overall strength of banks' balance sheets have facilitated a sharp increase in the amount of debt restructuring. As a result, we see little rationale for large-scale public intervention to promote private-sector debt restructuring. Nevertheless, the adequacy of the legal and institutional framework to support a major debt restructuring effort remains largely untested, and the paper argues that improvements to foreclosure procedures are needed to incentivize out-of-court restructuring, reduce credit enforcement costs, and increase the recovery rate.

The rest of the paper is organized as follows. The next section outlines the theoretical basis for government intervention in debt restructuring. This is followed by some stylized facts about the nature of private sector over-indebtedness in Latvia and the progress that has been made to restructure the debt. The next section assesses the case for further government intervention in debt restructuring in Latvia. We review the experience with debt restructuring in other countries and discuss why, in the Latvian context, the government's efforts to strengthen market-based debt resolution mechanisms are more appropriate than intervening directly in debt restructuring. The paper concludes with a brief review of the main findings and policy recommendations.

II. The Case for Government Intervention in Debt Restructuring

Past country experience suggests that a high level of distressed assets on banks' balance sheets could slow economic growth. A large stock of NPLs may constrain credit availability—especially among domestic banks that have been less successful at raising capital—as banks increase loan-loss provisions and tighten lending standards. In particular, past experience suggests that legacy problem loans undermine efficient financial intermediation as capital stays locked in nonperforming assets, interest income falls, and management resources are diverted.[3] In addition, a decline in the availability of credit may lower asset prices. For households, the resulting decline in wealth could reduce private consumption, while corporate investment could be adversely affected by the decline in collateral values which raises the cost of borrowing, and by the perception that the return on any new investments would only benefit existing debt holders. The resulting decline in domestic demand could put further downward pressure on prices and increase the real indebtedness of borrowers, thereby increasing the risks of a debt-deflation spiral. The macroeconomic impact of a debt overhang suggests that government intervention in debt restructuring may in certain circumstances be warranted.

[3] See, for example, Fisher (1933), Krueger and Tornell (1999), and Biggs et al. (2009).

Past country experience provides some guidance on when government intervention in debt restructuring—beyond efforts to strengthen the legal and regulatory environment and improve corporate governance—is desirable. Laeven and Laryea (2009) argue that government involvement—either through coordination of negotiations, information exchange, or by providing financial incentives—may be desirable if the debt overhang is so severe as to overwhelm the banking system, and the number of bankruptcies so large that it exceeds the capacity of the court system. Government involvement could also be warranted to overcome delays in restructuring that are optimal for individual debtors and creditors (by hoping for example that a future economic recovery will bail them out) but not for the economy as a whole, or to avoid costly collateral execution that generate negative externalities (e.g. on house prices in the case of foreclosures on real estate) that are not fully internalized by creditors.

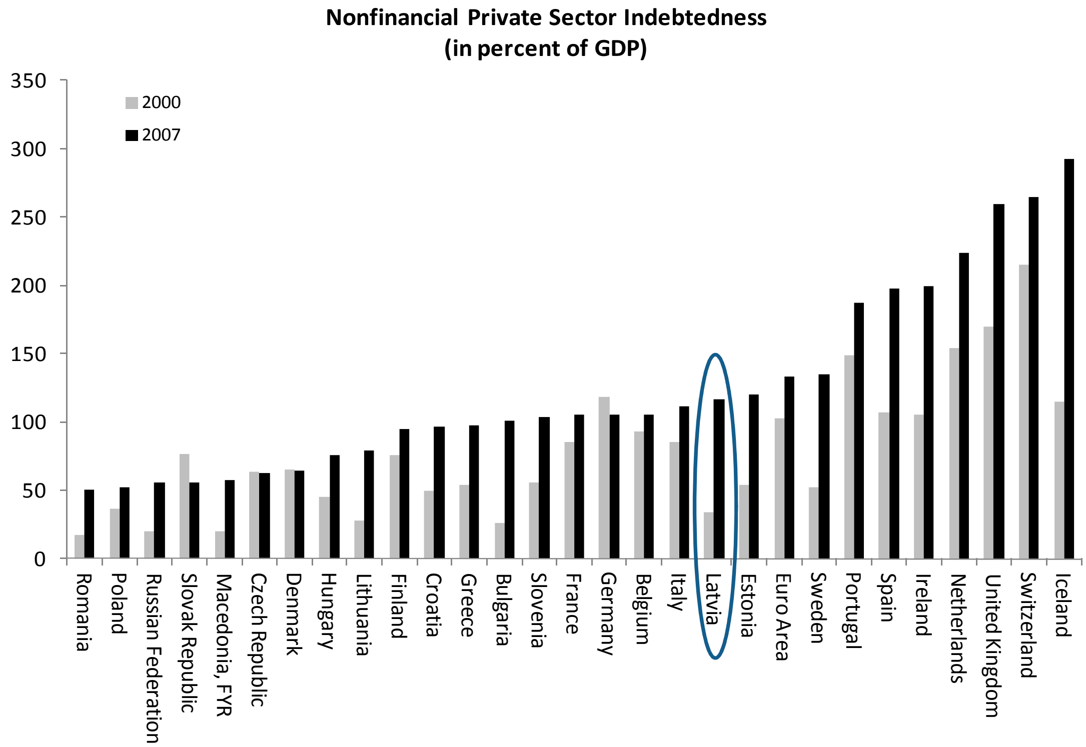
While government intervention could be used to promote debt restructuring, this needs to be weighed against the costs and distortions of any such intervention. In particular, government intervention could: (i) introduce moral hazard and adverse selection among borrowers, thereby weakening credit discipline, encouraging irresponsible risk-taking, and potentially reducing the availability or increasing the cost of credit in the future; (ii) help sustain non-viable firms, thereby hindering the adjustment necessary to promote future economic growth; (iii) create opportunities for politicization and capture by special interests and (iv) hurt public debt sustainability if intervention involves government financing, including direct government subsidies or guarantees. Therefore, government intervention should be considered only if there is clear evidence that a market-driven solution is insufficient to address wide-spread debt distress and that the public benefits of intervention will exceed its costs and distortions. The following sections explore to what extent government intervention in debt restructuring is warranted in Latvia.

III. Stylized Facts

A. The Credit Boom

The increase in the indebtedness of Latvia's NFPS prior to the crisis was the fastest among CEE countries and in Europe was only matched by Iceland and Spain. Credit to the NFPS—including borrowing from external creditors—increased by an average of 20 percent year-on-year between 2000 and 2007. As a result, Latvia's indebtedness reached 116 percent of GDP in 2007 compared to under 35 percent of GDP in 2000. Although the level of indebtedness was low relative to the euro area average of approximately 135 percent, it was above most CEE countries and high relative to Latvia's PPP adjusted GDP per capita.

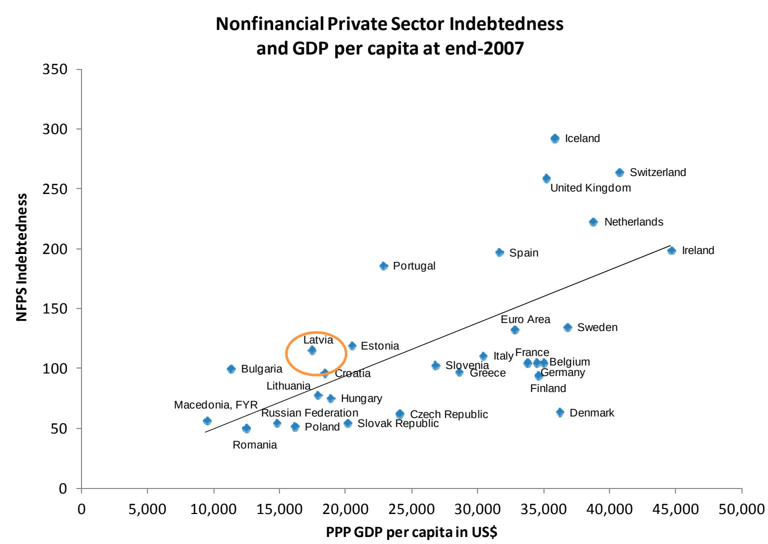
A comparison with CEE countries with floating exchange rates suggests that the fixed exchange rate regime in Latvia contributed to the build-up in credit. Bakker and Gulde (2010) note that Latvia like many other countries in the region experienced significant capital



Source: World Bank World Development Indicators

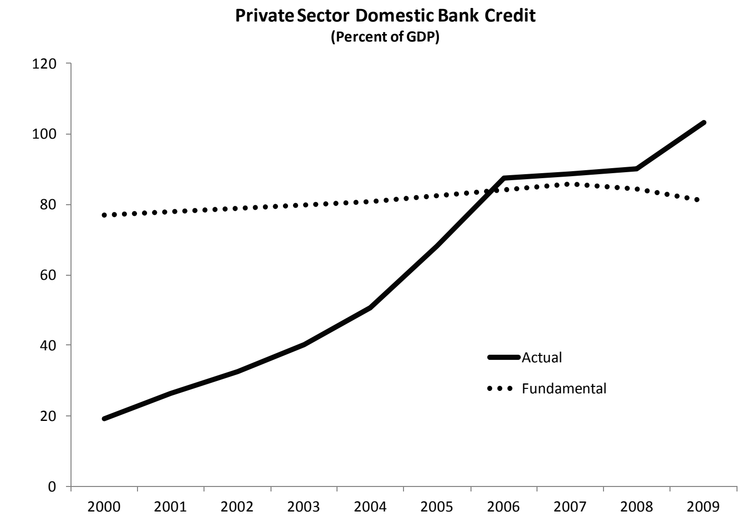
inflows in the years prior to the crisis. In countries with floating exchange rates (i.e., Czech Republic, Poland, Romania, Slovak Republic, and Ukraine) monetary policy was tightened by allowing the exchange rate to appreciate. However, in countries with currency boards and fixed exchange rate regimes (i.e., Bulgaria, Estonia, Lithuania, and Latvia) capital inflows led to inflation, lower real interest rates, and a sharp acceleration in credit. In many of these countries, including Latvia, most of the borrowing was in foreign currency given positive interest differentials and the lack of perceived exchange rate risk.

The credit boom in Latvia and the Baltics share many attributes with the East Asia crisis in the late 1990s. Both crises were characterized by a rapid build-up of private sector indebtedness, most of it in foreign currency, funded by foreign borrowing by domestic banks and corporate borrowers. Moreover, in both East Asia and the Baltics the financial sector is dominated by banks, which has made it difficult for corporates to find other sources of financing (Claessens et al. 1999). In the Asian crisis, however, much of the debt was



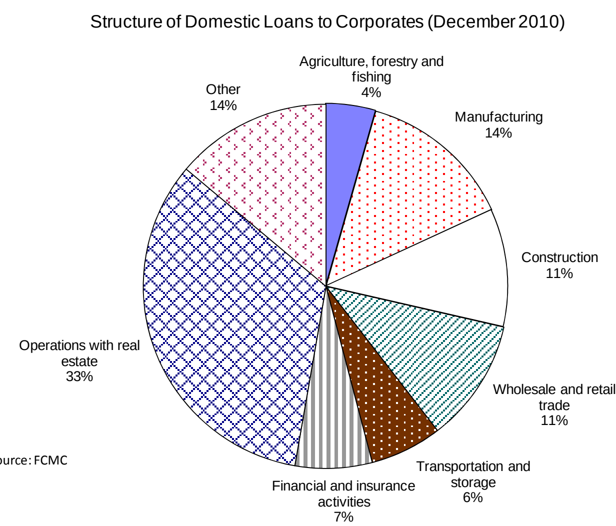
Source: World Bank World Development Indicators short-term and unhedged, leading to spiraling over-indebtedness in the wake of the currency devaluations. Furthermore, a large share of the debt was held by domestically-owned banks, while the prevalence of multi-creditor arrangements led to the creation of several government-led mediation entities. In contrast, in Latvia, the role of foreign-owned banks is larger, corporates typically only have one main creditor, and most corporate debt is medium-term.

The indebtedness of Latvia's NFPS—excluding external debt—is high relative to "fundamentals". Using an estimate of the "fundamental" private-sector domestic credit to GDP ratio (see Cottarelli et al., 2003 for details), which relates private-sector indebtedness to GDP per capita, public sector indebtedness, inflation, and indexes of financial liberalization, bank entry requirements, and accounting standards, suggests the indebtedness of Latvia's NFPS is about 22 percentage points of GDP above fundamentals.[4] For Latvia, however, this likely provides an incomplete picture of over-indebtedness given the importance of external borrowing by corporates which amounted to an additional 34 percent of GDP at end-2009.



Source: Staff Calculations

The corporate sector accounts for the majority of the indebtedness of the NFPS with domestic and external liabilities of 49 and 34 percent of GDP at end-2009. Corporate borrowing—notably in real estate—increased rapidly during the boom years, and domestic loans to real estate currently account for 33 percent of all domestic loans to corporates. At the same time, the leverage of Latvian corporates (measured by the debt-to-



Source: FCMC

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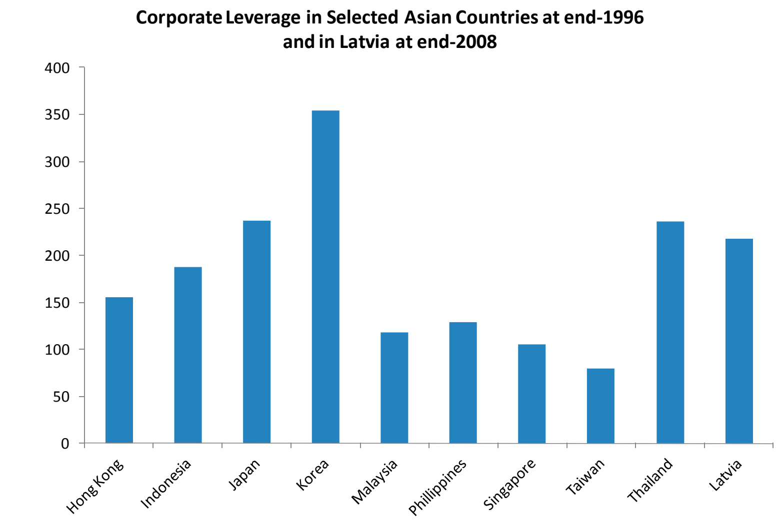
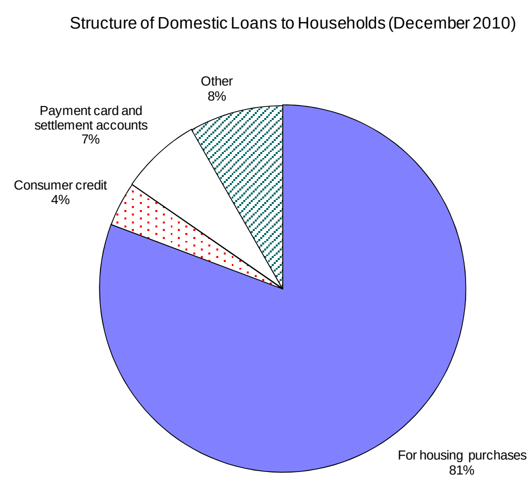
[4] See Cottarelli et al. (2003).

equity ratio) increased significantly from 120 percent in 2000 to 228 percent in June 2010—comparable to levels seen in several Asian countries in the years prior to the Asian crisis—contributing to an increase in vulnerabilities. Leverage varies significantly by sector and is particularly high in real estate at 471 percent and construction at 313 percent, while tradable sectors are in a more favorable position.



Source: Bank of Latvia and Claessens et al (1998), Corporate Growth, Financing, and Risks in the Decade before East Asia's Financial Crisis, World Bank Policy Research Working Paper

Household borrowing is heavily concentrated in loans for housing purchases and repair, with consumer credit relatively unimportant. Total household indebtedness amounted to 46 percent of GDP at end-2009, of which 81 percent were loans for housing purchases and repair. However, less than 20 percent of households are estimated to have mortgages compared to around 40 percent in the United States. This reflects in part the fact that most Latvians still live in Soviet-era apartments that were transferred to occupants as part of the transition to a market based economy. As in many other CEE countries, household mortgages in Latvia are therefore still not very common, with anecdotal evidence suggesting they are mainly concentrated among high income households.[5] The rental housing market is almost non-existent, complicating foreclosures of primary residences.

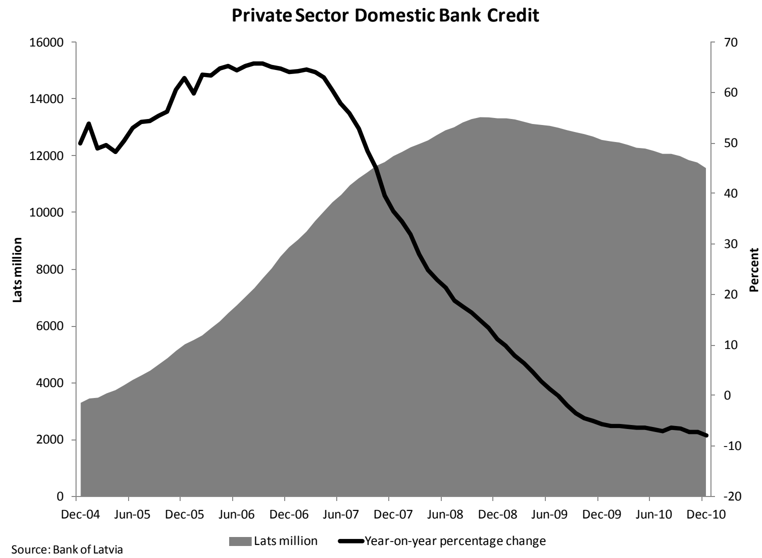


Source: FCMC

[5] No reliable data exist on mortgages by income.

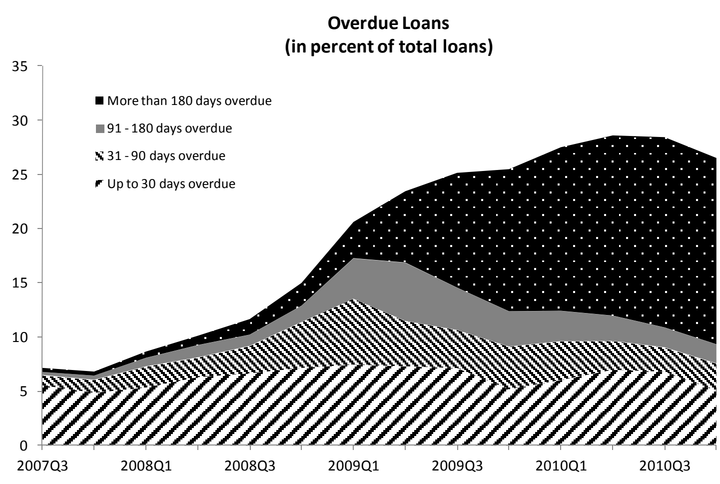
B. The Unwinding of the Credit Boom

Credit growth, which started to slow already in early 2007, turned negative in late 2008 as foreign-owned banks scaled back their exposure to Latvia and confidence declined. Purfield and Rosenberg (2010) note that Swedish banks operating in the Baltics gradually reduced their exposure given concerns about the sustainability of the real estate boom (two-thirds of bank loans in the region were backed by real estate), while domestic banks that relied heavily on foreign funding (notably non-resident deposits and syndicated loans) faced funding pressures as the global wholesale markets seized up following the demise of Lehman brothers.[6] Depositor confidence in the banking system was shaken by a deposit run on Parex Bank in the fall of 2008, prompting the government to nationalize the bank and to impose partial deposit withdrawal restrictions. As a result, deposits in the banking system declined by more than 10 percent in three months while private sector credit growth plummeted from an annualized rate of more than 50 percent in early 2007 to minus eight percent at the end of 2009.



The unwinding of the credit boom led to a sharp increase in debt distress.

- **NPLs appear to have peaked, albeit at elevated levels** (NPLs amounted to 19 percent of total loans at end-2010). In particular, the amount of new overdue loans—loans overdue by less than 30 days—has declined by nearly 40 percent in nominal terms since end-2008. At the same time, loans overdue by more than



[6] For a more general overview of the unwinding of the credit boom in Eastern Europe, see Bakker and Gulde (2010).

180 days remain high, suggesting that many banks are choosing to keep nonperforming assets on their balance sheets rather than write them off.

- **Anecdotal evidence suggests that a number of corporates experience debt distress as a result of their customers' insolvency.** This problem is exacerbated by the fact that, like in several other countries in the region, haircuts imposed on unsecured creditors in a debt workout are usually very high given the prevalence of secured (bank) debt.

- **Debt distress remains significant despite a fall in interest rates.** The debt service burden has declined due to lower euro interest rates and extensive debt restructuring by banks, while a recent analysis by Swedbank Latvia argues that the average monthly payment for a household mortgage has declined by 20–30 percent.[7] This reflects the fact that more than 90 percent of mortgages are denominated in euros and 75 percent are on flexible rates (the remaining 25 percent had an initial fixed interest period of 5 years). Given that most mortgages are less than 7 years old, interest payments still represent a significant fraction of total debt service. However, this positive effect has thus far been offset by declining household wages and corporate income, with the result that the debt burden has continued to rise.

- **Although Latvia experienced a significant increase in debt distress, the fixed exchange rate insulated borrowers from the balance sheet effects observed in several CEE countries with floating exchange rates.** Like in Latvia, several countries with floating exchange rates—including Hungary and Ukraine—also experienced a build-up in foreign currency lending in the run-up to the crisis. When the exchange rate depreciated this led to a sharp increase in these countries' debt burden. In Ukraine, for example, Grigorian and Raei (2010) note that many borrowers were left unable to pay their debts following the sharp depreciation of the hryvnya in late 2008 and early 2009, thereby contributing to a more than doubling of the NPL ratio from 17 percent in 2008 to 40 percent in 2009.

- **Experience from past crises indicates that NPL ratios could remain elevated over the medium term.** In particular, evidence from 15 emerging market countries in Asia and Latin America, as well as South Africa and Turkey, suggests that NPL ratios tend to rise rapidly in a crisis and remain more than twice as high as before the initial shock for more than four years.[8]

[7] See Swedbank (2010).

[8] For further details see Box 1.2 in IMF "Global Financial Stability Report", (2010).

C. Progress in Debt Restructuring

Although the stock of NPLs remains high, banks are reported to be actively restructuring problem loans. Based on reports to the Financial and Capital Market Commission (FCMC), 20 percent of the total amount of outstanding loans—approximately 23 percent of loans to legal persons (financial institutions, corporates and non-profit organizations) and 15 percent of household loans—are currently reported as restructured, more than double the amount at end-2008. Restructuring is defined by the FCMC as any concession to a borrower in financial difficulties, including e.g., all forms of rescheduling, capitalization of interest, and grace periods on principal repayment. This probably underestimates the overall amount of restructuring that has taken place since the economic downturn, as restructured loans that are performing for a year from the date when the first payment is due, are no longer classified as restructured. Some 70,000 household mortgages were classified as being restructured by the FCMC in Q3 2010, while a recent World Bank survey on corporate indebtedness in six Eastern European countries reports that approximately 63 percent of corporates have had some of their liabilities restructured in Latvia, second only to Hungary.[9] Restructuring in Latvia has been facilitated by the absence of debt securitization (so that the loan remains on the balance sheet of the original lender), the prevalence of single creditor structures (which limits creditor-coordination problems), and the fact that more than 60 percent of all outstanding loans have a maturity of more than five years, thus providing lenders more options for loan restructuring. The increase in restructuring also reflects efforts by banks to centralize loan workout and restructuring units and the re-allocation of staff to restructuring. Larger banks have also set up specialized wholly-owned subsidiaries to manage foreclosed real estate.

Anecdotal evidence suggests, however, that voluntary restructuring typically does not reduce the net present value of debt. In particular, restructuring usually involves granting grace periods on repayments or extending loan maturities, but offsetting this through higher interest rates and capitalization of interest. As the severity of debt overhang becomes apparent, banks are moving toward more aggressive methods of debt restructuring, including longer grace periods of up to 12 months, debt-equity swaps and debt-for-warrant swaps. It is unclear thus far whether this is sufficient to reduce the repayment schedule in line with the borrower's capacity to pay. As a result, there is a risk that a continued decline in household and corporate income, coupled with rising real rates due to deflation and an expected rise in EURIBOR rates, could put additional pressure on borrower's repayment capacity in the future.

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[9] See World Bank (2010).

The transaction costs of debt workouts are fairly high in Latvia when compared to neighboring Baltic countries, while recovery rates are relatively low. The majority of costs are fees to bailiffs and administrators who are compensated based on the recovery value. Moreover when real estate is sold in an auction, a two percent stamp duty is applied on the sales price (or cadastral value). While there is a cap of L30,000 per transaction, this applies to a single property, and is effectively not binding when commercial real estate (e.g. apartment buildings) is sold.

Table 1. Cost of a Bankruptcy Process in Different Countries in 2010

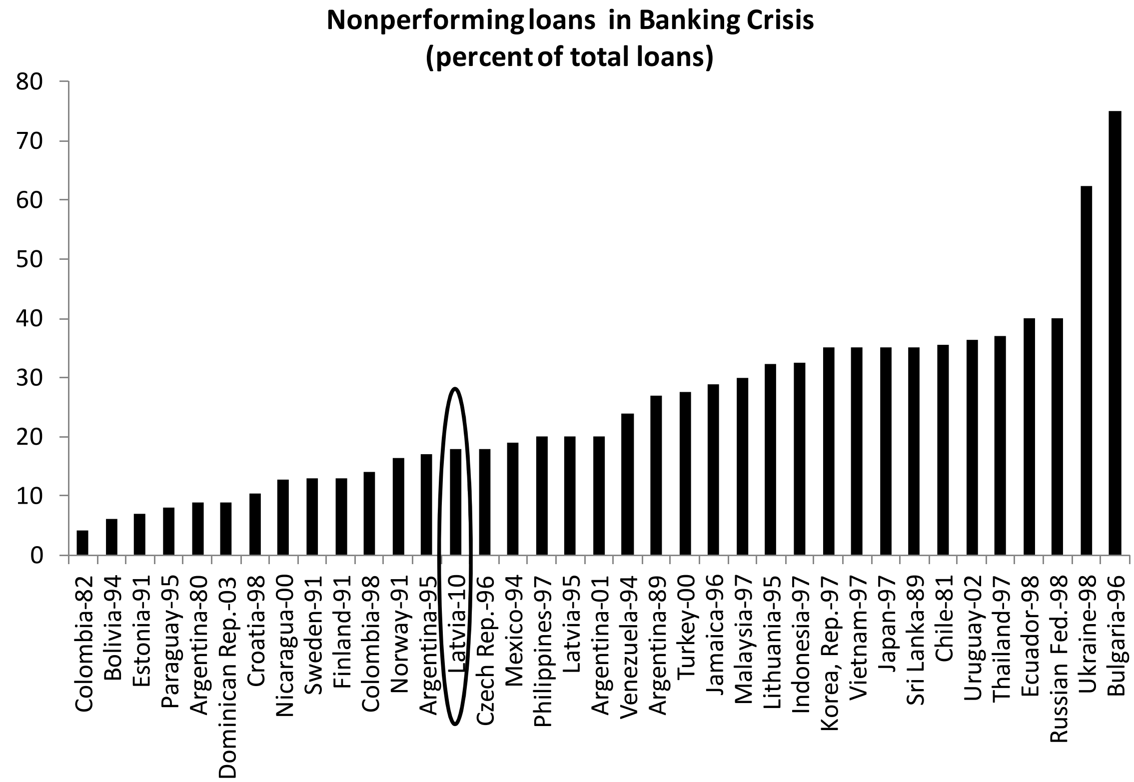
	Latvia	Estonia	Lithuania	Central and Eastern Europe and Central Asia	OECD average
Time (years)	3	3	1.5	2.9	1.7
Cost (percent of value)	13	9	7	13	9
Recovery rate (percent of estate)	32	36	50	33	69

Source: "Doing Business", World Bank, 2011.

Despite the reported increase in restructuring, the stock of NPLs remains high compared to other CEE countries—although still lower than in several other crisis countries.[10] At the same time, provisioning by Latvian banks appears adequate with the coverage of NPLs remaining steady at around 60 percent despite the sharp increase in problem loans during the crisis. Anecdotal evidence suggests that banks choose to keep these loans on their books or on the books of Asset Management Companies (AMCs) set up by the banks rather than foreclose or write them off because of the depressed price of collateral—in particular real estate—drawn out foreclosure and insolvency procedures, and the hope that most borrowers will recover their repayment capacity as economic growth resumes.[11] Tax disincentives (see the next section for a discussion of how these are being addressed) and slow court procedures are also likely to play a role. Foreclosures have therefore been limited to instances where the borrower is highly leveraged (e.g. real estate speculators), where there is little or no hope that the borrower will regain repayment capacity (e.g. if the borrower is in an industry such as construction or real estate development which is unlikely to recover to pre-crisis levels), or for properties that are not used as primary residencies. Evictions have so far been extremely rare, with banks preferring to lease repossessed properties back to previous owners.

[10] Note, however, that non-performing loans are not directly comparable across countries due to different loan classification rules. In Latvia, loans overdue for 90 days or more constitute NPLs and no allowance is made for the quality of collateral or other considerations.

[11] To improve the treatment of transferred problem assets and restructured loans, the FCMC issued a guidance to banks in early 2010 highlighting requirements on inclusion of AMCs and other subsidiaries into the scope of consolidated supervision, assessment of risk inherent to problem assets transferred to other entities within a banking group, and treatment of problem assets transferred to investment funds. Detailed reporting on restructured loans has been in place since 2009 to enhance offsite supervisory follow-up.



Source: FCMC and Luc Laeven and Fabian Valencia (2008), "Systemic Banking Crises: A New Database," IMF Working paper 08/224

IV. Government Involvement in Debt Restructuring[12]

A. Experience with Debt Restructuring in Other Countries

Government has played a role in debt restructuring in numerous countries.

- The "London approach" was developed under the aegis of the Bank of England as a set of informal guidelines to coordinate voluntary out-of-court debt workouts for corporates in distress.[13] The "London approach—which was widely used in the 1990s—recognizes that creditors will likely achieve better outcomes through collective efforts to support an orderly rescue of a firm in distress, instead of forcing it into formal bankruptcy.[14]

- The London approach was modified during the 1997–98 East Asian crises to enhance the role of centralized government agencies in coordinating and providing incentives

[12] This section draws on Laeven and Laryea (2009) and Laryea (2010).

[13] See Stone (2000) for details.

[14] After the Asian crisis, the International Federation of Insolvency Practitioners (INSOL International) published the Statement of Principles for a Global Approach to Multi-Creditor Workouts. These principles build on the London Approach, see http://www.insol.org/pdf/Lenders.pdf.

for restructuring. For example, government agencies in Indonesia, Malaysia, Thailand and Korea played a key role in the restructuring of the financial sector and corporate debt. In Indonesia the Jakarta Initiative Task Force (JITF) was a government agency established to facilitate out-of-court debt workouts by offering incentives (e.g. tax incentives and regulatory forbearance) and by imposing penalties (potential delisting and license revocation), while the Indonesian Bank Restructuring Agency (IBRA) was established to help restructure and recapitalize banks.

- Following the Latin American debt crisis in the early 1980s, the Mexican government provided refinancing and foreign exchange cover for private sector external debt and capital to nationalized banks combined with a comprehensive rescheduling of public sector debt. In Chile (1982), the government and the central bank provided direct subsidies to corporations and households through the exchange of foreign currency debt-service payments at a preferential rate, limited purchases of NPLs, and interest rate subsidies for household mortgages.

- Many countries have turned to centralized Asset Management Companies (AMCs) as a strategy for dealing with distressed bank assets.[15] Thailand, Korea, Malaysia, and Indonesia established centralized AMCs soon after the onset of the financial crisis in the late 1990s, while several of the transition economies in Central Europe and Central Asia—including the Czech Republic, the Slovak Republic, Mongolia, Kazakhstan, and Kyrgyzstan—set up AMCs in the wake of their bank crisis in the early 1990s. Recently, China established four AMCs to handle the bad loans of the four state-owned banks. Other examples include the Resolution Trust Corporation in the United States, the Swedish Securum, and the French Consortium de Realization, which was created as a subsidiary of Credit Lyonnais in 1995 to take over nonperforming assets from the bank before its privatization in 1999.

- Examples of government sponsored debt relief programs for small and medium-sized enterprises and household borrowers include: (i) the 1998 Punto Final program in Mexico where direct subsidies were provided to debtors to repay loans; (ii) Uruguay where the government introduced compulsory restructuring of small loans and strong regulatory incentives for restructuring of larger loans in 2000; (iii) the asymmetric pesofication and indexation of loans and deposits in Argentina in 2002 that imposed significant losses on banks and depositors and led to a dramatic loss of depositor confidence and a collapse in financial intermediation; (iv) Taiwan where in 2005 the authorities extended repayment terms on 30 percent of outstanding credit card balances, while granting regulatory forbearance to banks; (v) the United States where in 2008 the federal government introduced or sponsored a number of loan

[15] For details on the role of centralized AMCs in facilitating debt restructuring see Stone (2000).

modification programs aimed at stemming foreclosures, while some states imposed temporary foreclosure moratoriums; and (vi) the 2008 Homeowners Support Mortgage Scheme in the UK where the government guaranteed deferred interest payments on mortgages for a period of up to 2 years for eligible borrowers.

B. The Case for Government Intervention in Debt Restructuring in Latvia

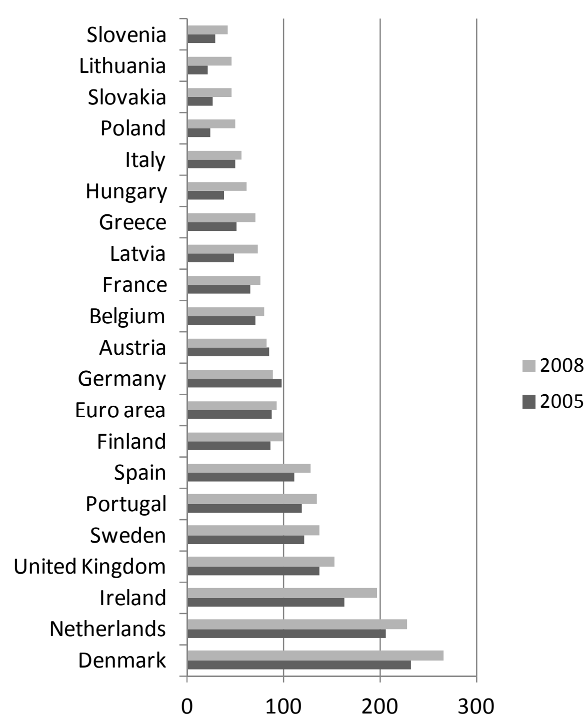
The case for government intervention in debt restructuring in Latvia is weakened by a number of factors.

- In Latvia, household gross debt increased rapidly during the boom year and amounted to 74 percent of income at end-2008. While higher than in most other new EU members, this is relatively low compared to countries in the euro area and other advanced economies. At the same time, the fact that mortgages are likely concentrated among high income households could help mitigate the wealth effects and makes it difficult to justify the use of public resources. Corporate indebtedness, however, is likely to weigh on investment moving forward—particularly in the real estate sector, which accounted for much of the investment during the boom years—given the high debt-to-equity ratios of corporates in Latvia and limited access to equity financing.

- There is little evidence that the large-scale market failures and/or externalities that complicated debt restructuring during the East Asian crisis exist in Latvia. In particular, the number of foreclosures so far appears insufficient to create significant negative externalities—as evidenced by the fact that real estate prices have been slowly increasing from a low point in September 2009.[16]

- The case for wide-scale government intervention in Latvia is severely limited by the available fiscal space and public debt sustainability concerns. Past government involvement in debt restructuring in

Household Gross Debt to Income Ratio



Source: Eurostat

[16] Large banks have been putting a floor on real estate prices by using wholly-owned asset management companies that participate in foreclosure auctions.

other countries was often very costly: the fiscal costs of past crises range from 20 percent of GDP for Mexico to 55 percent for Indonesia, a substantial portion of which was the fiscal cost of debt restructuring.[17] While Latvia's fiscal situation is improving, the adjustment necessary to restore medium-term sustainability remains significant. As a result, any government support for debt restructuring would have to compete with extremely scarce public resources.

- In the case of Latvia government intervention could also contravene EU rules limiting state aid to the private sector.

Notwithstanding the above, the Latvian authorities recognized early on in the crisis that the framework for market-based debt restructuring needed to be strengthened. Particular attention was focused on the need to facilitate voluntary out-of-court restructuring and refine insolvency legislation to better support effective rehabilitation of viable firms, including by expediting court approval of debtor rehabilitation plans, according priority status to new financing, and providing adequate protection for secured creditors.

C. The Authorities' Efforts to Facilitate Market-Based Debt Restructuring

For the reasons outlined above, the authorities have decided against using public funds to facilitate household debt restructuring. After a long discussion among stakeholders, a household mortgage debt restructuring scheme—under which the government would have guaranteed repayments on a portion of a rescheduled mortgages for a period of two years in exchange for a partial debt write-off at the end of the guarantee period if the loan was being serviced on schedule—has not been implemented. It was opposed by banks that saw it as too costly and administratively burdensome, and was also as problematic on distributional grounds as it offered little relief to the poor who typically do not have mortgages.

However, the authorities have made significant efforts to strengthen market-based debt resolution mechanisms in the context of the IMF-supported program.

- **The authorities are amending their tax legislation to strengthen the incentives for debt forgiveness.** The Ministry of Finance issued regulations in late-2010 to clarify that under the Enterprise Income Tax (EIT) law a loss resulting from principal write-off is a tax deductible expense. In addition, amendments to the EIT law have been approved by Parliament to ensure that the transfer of a distressed loan to a third party (including a commercial bank's SPV) at a fair market price is a tax neutral event. Amendments to the Personal Income Tax (PIT) law that waive personal income tax liabilities from debt write-downs—the "windfall income" resulting from a debt write-down is usually subject to a gift tax creating a tax obligation for borrowers

[17] See Laeven and Valencia (2008).

(which banks are expected to withhold) without an increase in cash flow—for a period of two years (2011–12) have also been approved by Parliament as a means to increase the incentives to faster debt resolution. However, further work is needed to ensure that value-added tax (VAT) obligations arising from the sale of foreclosed asset are collected in a consistent and uniform manner as the current regime of VAT collection is often not well understood by auction participants.

- **The authorities have strengthened the incentives for voluntary out-of-court debt restructuring** to avoid overwhelming the judicial system. Voluntary out-of-court restructurings provide a speedy, cost-effective, flexible and market-based tool for debt restructuring. To facilitate this approach, guidelines for out-of-court corporate and consumer mortgage debt restructuring were issued in August 2009. The guidelines for corporate workouts—developed with assistance from the World Bank and Fund staff—provide a set of high-level principles and guidelines for debt restructuring in line with international best practices.[18] The guidelines for consumer mortgage workouts—which draw on World Bank advice—provide a menu of approaches to resolve mortgage arrears.[19] Based on information from the FCMC, most banks in Latvia have incorporated these guidelines into their internal procedures.

- **The authorities have also improved the corporate insolvency regime to facilitate the rehabilitation of viable corporates and speed up the exit of non-viable firms (Box 1).** The insolvency law was amended in two steps. In July 2009 amendments to the law were made to strengthen the incentives to restructure corporate debt. The key improvements include (i) strengthening the incentives of all stakeholders to participate in Legal Protection Proceedings (LPPs) by introducing procedures for expedited court approval of restructuring plans agreed by parties before the filing of a bankruptcy petition; (ii) lowering the threshold for initiating proceedings to encourage debtors to file in the early stage of their financial difficulties; (iii) lowering the voting threshold for unsecured creditors to approve a rehabilitation plan from two-thirds to a simple majority so as to reduce the risk of holding up a viable plan; (iv) lengthening the rehabilitation period to a maximum of two years to give financially distressed firms more time to restructure; and (v) according priority repayment status to creditors that provide new financing. Building on the experience with the improved insolvency law regime, a new corporate insolvency law became effective on November 1, 2010 to streamline liquidation procedures to speed up the exit of nonviable firms and further refine LPP procedures. Amendments to other

[18] See http://www.tm.gov.lv/en/jaunumi/tm_info.html?news_id=3305.

[19] See http://www.fktk.lv/en/law/general/fcmc_guidelines_and_recommenda/2009-08-21_principles_and_guideline/.

credit enforcement laws that, inter alia, streamline collateral foreclosure procedures became effective in early 2010, increasing the incentives for corporates to participate in workouts by making collateral execution a credible threat.

- **The authorities have strengthened the personal insolvency regime to provide individuals with a viable exit strategy from extreme over-indebtedness.** As in most European countries, household loans in Latvia are "full-recourse" (i.e., an individual is not —except in the event of personal bankruptcy—released from the debt by collateral realization). Hence, it is important that the legal framework includes a mechanism that gives over-indebted but financially responsible individuals who are unable to reach a voluntary out-of-court settlement with their creditors a fresh start, thereby allowing them to become participants in the formal economy rather than disappearing into the grey economy. This mechanism also addresses instances of individuals providing guarantees for corporate borrowing. Latvia's personal insolvency regime was first introduced in January 2008 and improved in 2009—with technical assistance from the Fund—to make the proceedings faster and more accessible to debtors (Box 2). Building on this experience, a new personal insolvency law became effective on November 1, 2010. The new law provides financially responsible individual debtors a fresh start at the end of the insolvency proceedings by discharging their remaining liabilities after the sale of non-exempt assets and meeting the specified repayment requirements. The sharp increase in the number of personal insolvency proceedings—245 personal insolvency proceedings were filed with the court from August 2009 to June 2010, compared to only 57 cases in the 18 months prior to that—suggests that households increasingly consider this a viable tool to address over-indebtedness.

- **The authorities have implemented an information strategy to raise awareness about the improved legal framework and new debt restructuring tools.** A Consultative Council on Insolvency Matters composed of relevant state agencies and other stakeholders was established to discuss legislative proposals to refine the insolvency legal framework and out-of-court restructuring initiatives. In addition, the Ministry of Justice published articles and electronic leaflets in July 2009 on the amendments to the insolvency law as well as the new insolvency law and organized a series of educational seminars and workshops in collaboration with Fund and World Bank staff. Finally, training has been provided to judges and insolvency administrators to improve institutional capacity.

The authorities' efforts to strengthen the debt resolution framework have been complemented by a comprehensive set of measures to safeguard financial stability.

- In early-2009 the authorities undertook in-depth due diligence of all banks and carried out rigorous stress tests followed by a bank-by-bank assessment of the appropriate measures to address potential capital shortfalls.

- In March 2009 the FCMC issued revised regulations on asset classification and provisioning, as well as on implementation of the second pillar of Basel II, which gave supervisors better tools to enforce prudent provisioning and capital buffers.

- In December 2009 liquidity risk management and credit risk management regulations were revised to account for developments in international best practice, inter alia, by putting more emphasis on the management of funding risks and by specifying stress testing requirements and the criteria for determining the size of liquidity buffers. The revised regulations also specify the requirements for managing concentration risk and contingency plans.

- Financial sector supervision has been intensified, reporting frequency increased, and reporting on restructured loans enhanced.

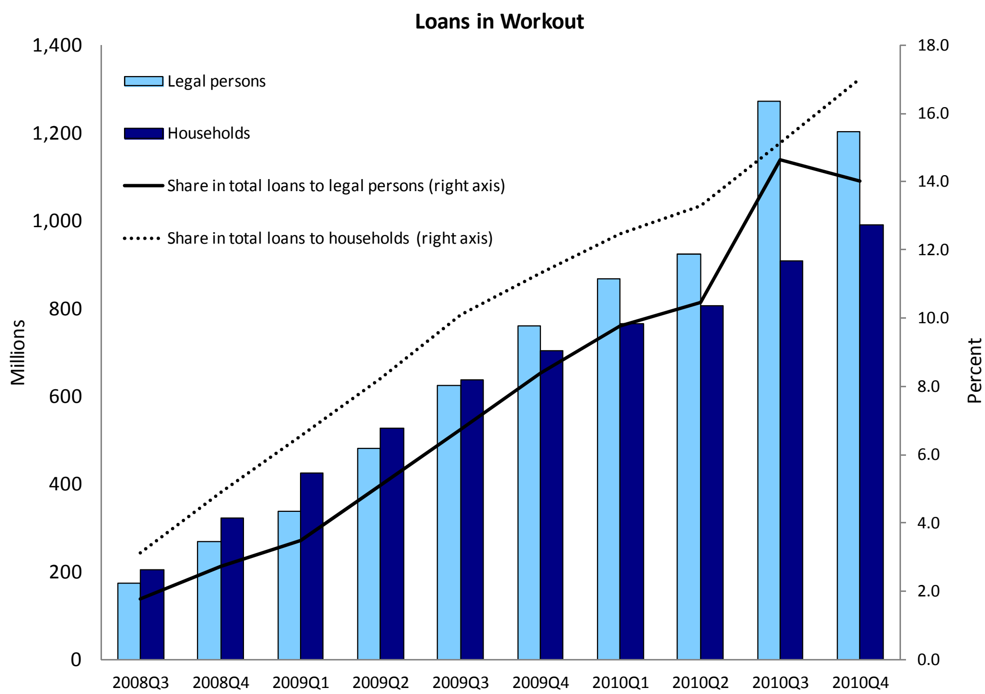
- The bank resolution framework and the effectiveness of the deposit guarantee system have been strengthened via amendments to the Banking Act and internal reorganization at the FCMC.

Thus far, the market-driven approach to debt restructuring does not seem to have been limited by the strength of banks' balance sheets and their capital positions. Debt restructuring adversely affects banks' earnings and capital position. In Latvia, the banking sector—and in particular the foreign banks that account for approximately 75 percent of mortgage lending—have engaged in significant pre-emptive recapitalization during 2009 and 2010, giving them a cushion to engage in the necessary restructurings or write-downs despite a significant rise in provisions. At end-2010 the system-wide capital adequacy ratio stood at 15 percent with the Tier 1 capital ratio close to 12 percent and relatively little variation among banks.

The large foreign participation in the Latvian banking system could facilitate debt restructuring by providing financial resources and technical expertise.[20] In particular, foreign-owned banks are likely to have sufficient capital buffers to recognize losses and have the infrastructure—including specialized AMCs—to manage distressed assets. On the other hand, the Scandinavian banks' (the dominant players in Latvia) experience during the past financial crises could make these banks more likely to adopt a "wait and see attitude" to collateral foreclosures and loss realization as a more patient approach resulted in reduced losses in other Nordic countries. Domestic banks in turn may face harder constraints since their capacity to withstand a drawn-out period of losses may be more limited, prompting them to move earlier to debt-to-equity swaps and other decisive restructuring.

[20] See Laryea (2010) for further details.

The efforts to strengthen market-based approaches to debt restructuring and the incentives for voluntary out-of-court debt restructuring are starting to yield results. The volume of restructured loans has increased more than nine times since end-2008, while the volume of loans classified by banks as being in "workout"—implying that the bank is in the process of foreclosing on collateral, invoking guarantees, or has initiated legal proceedings to enforce a claim—has almost trebled based on FCMC data. Data from the Ministry of Justice shows that the number of initiated LPPs has increased from 13 cases in 2008 to 201 cases from July 2009 to October 2010. Despite these improvements, however, the full benefits of the reforms of the insolvency framework have yet to materialize as market participants and the legal system will need time to get familiar with the new legal framework. Furthermore, there is not yet any experience with completed LPP cases as these involve a two year rehabilitation plan (the first cases under the new framework will be completed in late 2011). As a result, it is too early to conclude definitively whether the tools currently available to creditors and debtors are sufficient to deal with the magnitude of debt distress in Latvia.



Source: FCMC

V. CONCLUSIONS

This paper has assessed the case for more direct government involvement in debt restructuring in Latvia. Although the amount of debt distress remains considerable, the scale and characteristics of distressed household and corporate debt in Latvia does not seem to warrant public intervention beyond ensuring a supportive legal and regulatory framework. The banking sector has capital to absorb losses, coordination problems are not overwhelming, and foreclosures have not been sufficiently widespread to create significant negative externalities.

At the same time past country experience with wide-scale government intervention in corporate debt restructuring has been decidedly mixed.[21] The fiscal cost of government intervention has often been significant and has in several cases—including Chile and Mexico—proved harmful to public debt sustainability. Moreover, experience with centralized AMCs—including the Indonesian Bank Restructuring Agency—has also been mixed, with these companies typically more useful for taking distressed assets of banks' books and thus stabilizing the banking system, rather than supporting corporate debt restructuring.

The efforts the authorities have undertaken to strengthen the regulatory and legal framework for debt restructuring are starting to yield results. The improvements to the corporate and household insolvency regime have led to a sharp increase in LPPs and personal insolvency proceedings, while the increase in debt restructuring reported by banks suggests that the strengthening of the voluntary out-of-court debt restructuring framework is yielding results. At the same time the capacity of the institutional framework to support large-scale individual debt restructuring in the wake of recent legal reforms remains largely untested, and it is too early to conclude definitely whether the debt restructuring framework is sufficient to deal with the magnitude of debt distress in Latvia.

Notwithstanding the above, **the high level of legacy problem loans suggests that further changes to foreclosure procedures, strengthening of the court system, and changes to tax legislation are needed** to improve the incentives for writing down loans, reduce credit enforcement costs and increase the recovery rate:

- Amendments to the Civil Procedure Law that allows the winning bidder to obtain a bank guarantee letter—instead of a bank loan which would require the buyer to pledge the asset auctioned as collateral—to facilitate the simultaneous payment of the auctioned property, transfer of title, and vesting of the first priority security interest in the bank, recently became effective. This should help increase the number of successful auctions and facilitate price-discovery, although their effectiveness is yet

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[21] See Laryea (2010) for further details.

to be seen. Efforts should also be made to streamline the post-auction court approval process in order to speed up foreclosure procedures and reduce their cost.

- The overall fees for bailiffs remain high compared to neighboring countries and consideration should be given to reducing the level of compensation while improving the incentive structure in line with international experience.

- The capacity of the court system to handle large scale insolvencies remains untested. However, market participants frequently complain about the delays and unpredictability, as well as the inconsistency of rulings. Further efforts are therefore needed to educate judges about the changing debt restructuring and insolvency framework, to streamline court procedures, and to standardize the training of administrators.

- Important steps have been taken to ensure that the tax legislation in Latvia does not discourage effective debt restructuring. In addition, consideration should be given to reducing (and eventually abolishing) the current two percent stamp duty[22]. Moreover, steps should be taken to remove any uncertainty among market participants about who should collect value added tax (VAT) from the sale of a foreclosed asset and transfer it to the state budget.

[22] Authorities need to weigh debt restructuring benefits against a potential revenue loss. Similarly to some other countries, one could consider a possibility of exempting transactions that relate to debt restructuring only, but these would need to be legally defined. For instance, in the aftermath of financial crisis in Turkey, the law on restructuring of debts to financial sector passed in 2002 introduced a set of tax exemptions for contracts restructured according the conditions set in this law until end-2004.

Box 1. Options for Corporate Debt Restructuring in Latvia

Effective and efficient insolvency procedures are essential to facilitate corporate debt restructuring, thus helping resolve debt distress. They provide a collective credit enforcement mechanism that establishes incentives to catalyze out of court restructurings of viable firms and support speedy exit of nonviable firms from the economy. When there is a risk of wide-scale insolvencies that cannot be handled by the court system, a structured out-of-court framework becomes critical. Such a framework needs to be supported by an insolvency law that defines rights and obligations of parties in a transparent, balanced and predictable manner, as well as other laws (e.g., tax laws).

The following instruments are currently available for corporate debt restructuring in Latvia:

- **Voluntary debt workouts** between debtors and creditors (facilitated by out-of-court restructuring guidelines for corporate debt issued in August 2009). As most creditors are either domestic or foreign banks, restructuring is typically a bank-led process. The foreclosure procedures have been refined to speed up the debt resolution process by reducing the number of auctions and shortening the auction notice period.
- **Legal protection proceedings (LPPs)** to rehabilitate viable firms which consist of: (i) expedited procedures for court approval of a rehabilitation plan negotiated between parties before filing of an insolvency petition; and (ii) in-court procedures for development of a rehabilitation plan after filing a petition but before commencement of the LPP. A legal person may petition the court to initiate LPP if it meets certain conditions. A rehabilitation plan has a length of two years, which can be extended for another two years by two-thirds of secured creditors and a simple majority of unsecured creditors, and may include different restructuring tools including debt for equity swaps or debt forgiveness. The plan covers both secured and unsecured claims, and must be approved by two-thirds of secured creditors and a simple majority of unsecured creditors based on the outstanding principal amount, provided secured claims cannot be modified without secured creditors' consent. If the debtor fails to implement the LPP plan, the law allows for a conversion of the LPP to a bankruptcy (liquidation) proceeding. The commencement of the LPP triggers a stay on all enforcement actions.
- **Bankruptcy proceedings** may be initiated by a creditor, a debtor or an administrator. The bankruptcy process is managed by a court-appointed insolvency administrator who prepares a liquidation plan that includes the costs of bankruptcy proceedings and the procedures for compensation of creditors' claims. The administrator shall decide to sell a debtor's property in a public auction or a private sale and the proceeds will be distributed in accordance to the priority list specified in the law.

Box 2. Insolvency Procedures for Individual Debtors in Latvia

On November 1, 2010 a new insolvency framework for individuals with the objective of facilitating a resolution of over-indebtedness when individual debtors are not able to reach a voluntary agreement with creditors, became effective. Under the framework, an individual debtor will be fully discharged from his/her remaining debt liabilities after successfully implementing a repayment plan closely monitored by the court.

Personal insolvency proceedings may be initiated at the request of the debtor if he or she is unable to pay overdue debt in an amount exceeding L5,000 or debt exceeding L10,000 falling due within one year, and is able to pay a one-off administrator fee of two minimum monthly salaries. The proceedings consist of two components: (i) bankruptcy proceedings where the nonexempt assets of a debtor are sold and proceeds are distributed to creditors, followed by (ii) the obligation settlement proceeding where the debtor prepares a repayment plan which must be approved by the court. The repayment plan is based on the following: (a) if during the obligation settlement proceedings the debtor's income is sufficient to cover at least 50 percent of the remaining obligations after the completion of the bankruptcy proceedings (i.e., sale of nonexempt assets), the term of the obligation settlement plan shall be one year from the date of the announcement of the obligation settlement proceedings; (b) if the debtor's income is sufficient to cover at least 35 percent of the remaining obligations, the term shall be two years; (c) if the debtor's income is sufficient to cover at least 20 percent of the remaining obligations, the term shall be three years; (d) if the debtor's income is insufficient to cover 20 percent of the remaining obligations, the term shall be three years and six months; and (e) if the debtor's total obligations at the time of the commencement of the insolvency proceedings do not exceed L100,000 and the debtor's income is insufficient to cover at least 20 percent of the remaining obligations, at least one third of the debtor's minimum monthly salary shall be directed towards the settlement of creditors' claims for two years from the commencement of the obligation settlement proceedings.

The framework includes numerous safeguards to protect individual debtors. In particular, the commencement of personal insolvency proceedings halts collection of outstanding claims by creditors and triggers a stay on enforcement actions. Moreover, while secured creditors may request the sale of pledged collateral in an auction, the sale of the pledged property that is used as primary residence may be put off for up to one year from the commencement of insolvency proceedings if the debtor lives with dependents and if the cadastral value of such property does not exceed L100,000.

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