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Debt Relief or Exit: The Long-Term Effects of Forex Loans on Latvian Households

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Abstract*: The stubborn decision of the Latvian government to join the eurozone at any cost put a great burden on Latvian households after the crisis of 2008. Nevertheless, no popular protest movement emerged to change the course of this decision. This study discusses why Latvians undertook individual strategies to cope with the forex loan crisis. Particularly, I look at the choice between formal debt relief procedures and emigration as alternative individual strategies for defaulted debtors. These programmes have not reversed the negative migration trends or significantly decreased the number of Latvian households in arrears. Debt discharge is mainly attainable for wealthy individuals who are able to mobilise their financial and kinship resources. Worse-off debtors cannot attain debt discharge or are stigmatised during the process. Alternatively, emigration has offered a way to cope with overindebtedness and keep up with mortgages and consumer loan payments for a much larger segment of the debtor population.*

Keywords: Latvia; forex debt; debt relief; mortgages; emigration.

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Introduction

Since accession to the European Union (EU) in 2004, credit growth and capital inflows in the Baltics (i.e., Latvia, Lithuania, and Estonia) has exceeded the growth and inflows observed in other Central and Eastern European economies (Purfield and Rosenberg 2010: 4–5). Transnational financial integration within the EU led to the rapid development of the Latvian mortgage market, which was almost non-existent before the early 2000s. Backed by Swedish banks' aggressive lending strategies, Latvia soon became one of the most financialised economies in East-Central Europe (Bohle 2018a). Economic growth was driven mainly by massive foreign investment in non-exporting industries and debt-driven consumption of foreign goods (Blyth 2013: 204–212; Toporowski 2011: 238–40). As a result, Latvia entered the Global Financial Crisis (GFC) with extremely high levels of accumulated household loans: in 2008 there were liabilities of over €5.5bn across 823,000 households (FKTK 2015).

Like other countries in Central and Eastern Europe, around 80% of the loans to Latvian households were given in a foreign currency. At the same time, Latvia, along with the other Baltic countries, differed from some of their East-Central and South-East European counterparts in two important aspects. First, Latvian households did not experience the shock of the rising exchange rate of the Swiss franc, as most forex loans were given in euros (Bohle 2018b). Second, the Latvian government decided to keep its currency pegged to the euro to safeguard its euro adoption process, which it completed in 2014 (Bohle 2018c; Hilmarsson 2018). For this purpose, Latvia embarked on a process of 'internal devaluation' by dramatically decreasing public sector spending and drastically driving down wage levels (Åslund and Dombrovskis 2011; Purfield and Rosenberg 2010; Sommers 2018).

The burden of the crisis was thus placed on households. Soon after, the share of non-performing loans reached a level as high as 20%, well above the EU average of around 10% (Erbenova, Liu, and Saxegaard 2011). The Latvian government did not enact financial repressions against banks, as the bank lobby effectively staved off any such attempt (Ban and Bohle 2021; Eglitis 2015). On the contrary, in close coordination with financial institutions, the government offered an individual solution to the overindebted, namely, an individual insolvency procedure that was introduced in 2008. Since then, close to 10,000 debtors have succeeded in reaching debt discharge as the desired outcome of the procedure. Many more, around 200,000 Latvians, have emigrated abroad – often, I will argue, to improve their balance sheets.

These two individualistic solutions – insolvency procedure and emigration – are almost always discussed jointly in Latvia (see, e.g., Bank of Latvia 2020; Bērziņš 2014). This framing of the forex-loan mortgage crisis has overshadowed any proposals for collective action regarding household debt management. The emphasis on the indebted household to solve the financial constraints on its own fits the larger narrative associated with European post-communist societies of disinterest and disengagement in political and social activism in favour of individual solutions to crises (Rasnača 2014:5). Indeed, no popular social movement that would primarily address the overindebtedness issue emerged in Latvia after the GFC. This has allowed the Latvian government to take a non-interventionist approach to household credit market (Ban and Bohle 2021).

This paper contributes to the debate on the foreign-currency mortgage crisis in Eastern Europe in two important ways. First, I consider the individual insolvency process an important part of

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post-crisis management. Although the formal debt relief process directly addresses the mortgage and consumer loan crisis, the current literature on responses to the GFC in Eastern Europe largely focuses on the austerity measures, reforms in the public and housing sector, and migration (Bohle and Seabrooke 2020; Cepilovs and Török 2019; Dzenovska 2018; Natili et al. 2019; Nyblom et al. 2019; Sommers 2018). Second, I show that a significant, albeit small, part of Latvian society was able to act against the financial institutions and attain debt relief. This is counter to the popular narrative that individuals in the post-communist countries 'keep their heads down and work even harder than before, in the hope or expectation that this crisis would (like previous ones) eventually blow itself out' (Bideleux 2011: 339). My analysis of Latvian households' post-crisis behaviour shows that accepting individual solutions for overindebtedness – instead of demanding and introducing collective ones at the political level – creates deep social divisions. Those with financial resources and high management skills navigate the expensive and complex insolvency process and gain 'a fresh start'. At the same time, a much larger part of the population is forced to emigrate or faces stigmatisation during the debt relief process.

In what follows, I discuss the various debt relief procedures that Latvian governments have introduced since the GFC in relation to the emigration of Latvians. Over the years, three different debt relief procedures have become available to Latvians. On the surface, it looks like debt relief is becoming more accessible. However, these developments are not driven by citizen initiatives but are brought to the table by the bank lobby and serve their business interests. As a result, many Latvian emigres with mortgage loans are unable to return, as debt relief procedures are hardly available to them. This shows that Latvia is still a financially captured state (Ban and Bohle 2021) in which business interests prevail in the management of the forex loan crisis and a wider regulation of housing finance.

The first crisis response: the individual insolvency process

The current individual insolvency procedure was adopted in November 2010, replacing the first version introduced in 2008. During its short life of nearly three years, the first procedure attracted only a handful of applications – around ten each month – due to legal and financial barriers. The new procedure introduced in 2010 made it accessible to a broader population. The defaulted debtor had to have arrears of at least €5,000 to be eligible for the procedure, which is an amount equal to five average monthly salaries.[1] Therefore, the debtor must have accumulated significant arrears before the application. The threshold is more easily attainable for those with larger repayment instalments, implying a larger mortgage. It is almost unattainable for holders of defaulted consumer debts, as they rarely reach the necessary threshold.

To fulfil the aforementioned requirement of arrears, some debtors sign a fictitious agreement for a loan of a few thousand euro with somebody close – a friend or a relative – and formally default on the newly taken debt.[2] Alternatively, others inflate their debt portfolio with additional liabilities and quickly default on them. The insolvency court proceedings show that, on average,

[1] The required amount has gradually been decreased from the original €7,714 in 2008.
[2] The interviews for this study were carried out with 15 individuals who had applied for the insolvency procedure during fieldwork in Riga, Latvia, from May 2019 to January 2020.

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one out of ten insolvent individuals owed a debt to a natural person.[3] Around the same share (8%) had defaulted on payday loans. Some insolvent individuals had as many as ten loans from payday companies. Hence, the requirements of the insolvency procedure seem to lead individuals to increase their debt portfolio. However, taking up more debt is related not only to achieving the necessary threshold for arrears. At the time they make their application, individuals have to pay nearly a thousand euros in upfront fees. As discussed by the insolvent interviewees, payday loans and relatives are also the key resources for overcoming this barrier to eligibility.

Insolvent individuals, i.e. those at risk of default, are usually debtors who have mortgages and are divorced or unemployed (Backert et al. 2009; Laws 2020; Porter 2012). This is not the case in the population of insolvent persons in Latvia. First, unemployed individuals are not eligible for the insolvency procedure. Second, most individuals applying for insolvency do not own any assets and only have unsecured loans. In many cases, real estate was foreclosed well before the insolvency process. In other instances, the insolvent individual was not the original holder of the debt but only a co-signer, as many mortgages are secured by both property and personal liabilities of family members or close friends (Sommers 2018). Third, as disclosed by many interviewees, individuals apply for insolvency only after getting rid of all their assets that could be sold off – for instance, by giving them to family members or signing a marriage contract with the spouse. The contract specifically prescribes that all assets belong to the spouse and, therefore, are not subject to sell-off during the insolvency process. Among the married insolvent individuals, one in ten has a marriage contract, which is three times more than in the general population.

All the issues discussed above indicate that the insolvency process is a rocky road that only a sophisticated debtor can pursue. The procedure cannot be pursued soon after a household experiences its first financial shock, as it takes months – if not years – to become eligible. The insolvency path is taken if the household has enough financial resources to settle all the legal requirements and financial expenses, including those that arise from hiding away real estate. It is not accessible for individuals in material deprivation.

The second crisis response: emigration

Massive emigration and deepening ethnopolitical cleavages are the most common explanation for why no political mobilisation occurred during the crisis (Bohle 2018c). Indeed, up to 200,000 Latvians, or around 10% of the total population, emigrated abroad in the crisis aftermath (Hazans 2011, 83). Soon after, remittances from Latvians abroad significantly increased so that in 2014 they were estimated to make up as much as 3.7% of Latvia's GDP (Klūga 2015; World Bank n.d.).

Every two in five (40%) Latvian emigrants abroad in 2019 stated that financial hardship and inability to find a job were the reasons they left Latvia.[4] At the same time, most of them said they did not own real estate or have a mortgage. This suggests that emigration during and after

[3] The analysis is based on data gathered from the insolvency court proceedings of 5,119 cases initiated in 2011–2014.
[4] The analysis is based on survey data on 4,975 Latvian emigrants collected online from September to November 2019 by the Institute of Philosophy and Sociology at the University of Latvia (Mieriņa et al. 2021).

the crisis was not triggered by the mortgage crisis as much as by the lack of employment and financial constraints triggered by massive forex lending and debt-driven consumption. As the Insolvency Act makes it hard – if not impossible – to apply for debt discharge without having a mortgage, unemployed debtors with consumer loans were much more likely to emigrate.

Around ten years after the crisis, only 15% of emigrants stated that they could not return because of unpaid debts in Latvia. Hence, emigration has solved the issue of overindebtedness for many Latvians abroad. At the same time, among emigrants with mortgages, a much larger proportion still struggle. One in four (27%) emigrants with a mortgage stated that they could not return because of unpaid debts in Latvia. Although the insolvency process promises to provide debt relief and a fresh start, these individuals remain abroad and make payments for houses they do not reside in.

The third crisis response: more debt relief or more stigma?

The unsolved debt issues of Latvian households have not gone unnoticed by the political and business elites. Despite the introduction of the insolvency procedure and massive emigration after the GFC, the share of households in arrears has remained above the average for the European Union. As of 2020, it is estimated that nearly one in ten individuals in Latvia struggle to pay off their debts (Eurostat n.d.). The household debt issue has never left the orbit of the emigration issue: proposals for collective debt management measures are invariably discussed within the debate on how to enable Latvian emigrants to return home.

In the past two years, the parliament has adopted two new procedures for debt discharge. One addresses specifically people with defaulted consumer loans; the other allows banks to write off defaulted mortgage loans issued before 2009 unilaterally. Both initiatives were proposed by the Finance Latvia Association, the lobby group of the Latvian financial sector. The former process is hardly accessible and is even stigmatising; the latter is currently rarely used by the banks.

The debt discharge procedure for consumer loans has been available to defaulted debtors since January 2022. Individuals holding a debt of less than €5,000 in total and no mortgage can apply for the relatively simple, fast out-of-court procedure. It is much cheaper than the insolvency procedure, as the legal fee is only €100. However, like the Insolvency Act, this procedure sets several barriers to eligibility. The income for the applicant in the last 12 months cannot be equal to or greater than the minimum wage. Additionally, for at least three months in the year before the application, the defaulted debtor must have been officially declared poor by the local or state authorities. The process is also unavailable to Latvians living abroad, as the defaulted person must have resided in Latvia in the last 12 months before applying. In addition, the steps that individuals must take before and after their debt is discharged makes the process quite stigmatising. First, the debtor must take a course in financial literacy. Second, after the debt is discharged, the individual must visit social services for consultation 'to identify whether he [sic] is not a social services client'. Finally, after the debt is discharged, the individual remains under a 'monitoring regime' with limited economic activity for two years. The near-to-mid future will show how many of the so-called 'no income, no assets' debtors are able and willing to fulfil these requirements to attain debt relief when other European countries, such as Germany, have failed in this task (Heuer 2020).

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The second recently introduced mechanism - the ability for financial institutions to unilaterally write off defaulted mortgage debts – has been available since August 2020. The initiative found its way into Parliament soon after Mārtiņš Kazāks, the ex-chief economist of the largest Latvian bank, Swedbank, became the president of the central bank of Latvia. Arguing his support for the initiative, he linked the law with emigration: 'I hope this will help some debtors move out of the shadow economy and re-emigrate. Citizens could start all over again – participate in economic life without a historical anchor pulling them underwater' (Bank of Latvia 2020). As in the case of debt relief for consumer debts, eligibility is relatively limited. It applies only to loans taken out before 2009 and secured by a mortgage on real estate that was foreclosed no later than 2018. It is estimated that around 13,000 individuals could be eligible for debt relief under this mechanism. However, creditors decide unilaterally if debt relief should be given and can introduce additional eligibility criteria.

Conclusion

This study looked at Latvian individuals who defaulted on a debt and it weigh two possible ways of solving their financial distress: applying for a debt discharge or emigrating. Even though there are currently three debt relief mechanisms available, they are all strictly individual and apply to a small minority of defaulted debtors. So far, debt relief has been granted mostly to financially well-off individuals who can navigate the burdensome legal procedures, pursue various ownership strategies, and afford the legal fees. It is questionable whether such households can be considered to be in financial distress.

Hence, it is difficult for a large subset of financially distressed individuals to achieve debt relief. Moreover, none of the procedures provides immediate help after the financial shock. This status quo makes Latvian households vulnerable to any future financial crisis. Because of the lack of collective solutions for debt management at the state level, emigration has been the most effective strategy for Latvians to manage their debts. Whether the recently introduced debt relief procedures will change the course remains to be seen.

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