

Buchen, Teresa; Drometer, Marcus; Oesingmann, Katrin; Wollmershäuser, Timo

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MANAGING HOUSEHOLD DEBT IN CROATIA

TERESA BUCHEN*, MARCUS DROMETER**,
KATRIN OESINGMANN** AND
TIMO WOLLMERSHÄUSER**

Household debt in Croatia

Household debt in Croatia has risen considerably since the turn of the century, from 17 percent relative to GDP in 2001 to 41 percent in 2014. As shown in Figure 1, it was the highest household debt-to-GDP ratio, together with Estonia's, among the CEE10 countries¹ in 2014 (Eurostat 2015, European Commission 2014 and 2015).

More than 70 percent of all loans to households and non-financial and financial corporations are denominated in or indexed to a foreign currency, mainly the euro and the Swiss franc. This is the highest ratio in the European Union (ESRB 2015). Apparently, households fall for an exchange rate illusion: by considering only the fact that interest rates on foreign-currency loans are lower than those on kuna loans, they ignore the risk of currency depreciation. This may be reinforced by the exchange rate policy of the Croatian National Bank, which aims to guarantee stability through the quasi-peg to the euro. But between 2009 and April 2015, the kuna depreciated by 7 percent against the euro and even by 36 percent against the Swiss franc. The Swiss franc/kuna exchange rate stabilized when the Swiss

* Credit Suisse Zurich.

** Ifo Institute.

¹ CEE10 = ten countries of Central and Eastern Europe (CEE) including Bulgaria, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Slovenia and Slovakia.

National Bank introduced the exchange rate floor to the euro, but depreciated by an additional 14 percent when the floor was removed in January 2015.

Depreciation and the protracted recession in Croatia have made it difficult for many households to service their debt. The share of non-performing loans among households – that is, loans that are in or close to default – has trebled in the course of the recession, from 4 percent at the end of 2008 to 12 percent in June 2014 (see Figure 2). A substantial share of the population is not even able to pay their utility bills. Due to this, 313,830 bank accounts were blocked as of August 2014 (FINA 2014), which corresponds to about 7 percent of the population (assuming that every citizen has only one bank account).

Ad-hoc measures by the Croatian government

The Croatian government has taken several *ad-hoc* measures to cushion some of the negative effects of household indebtedness. In particular, the issue of blocked bank accounts has been addressed by the Fresh Start Program, which consists of debt relief for the poorest households (Government of Croatia 2015a). The Consumer Credit Act was introduced on 15 January 2015 to offset the effect of the appreciation of the Swiss franc, and the corresponding increase in

Figure 1

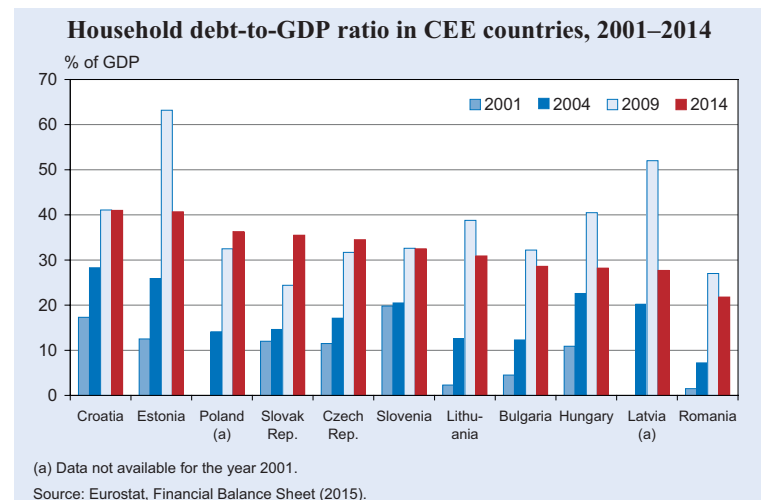
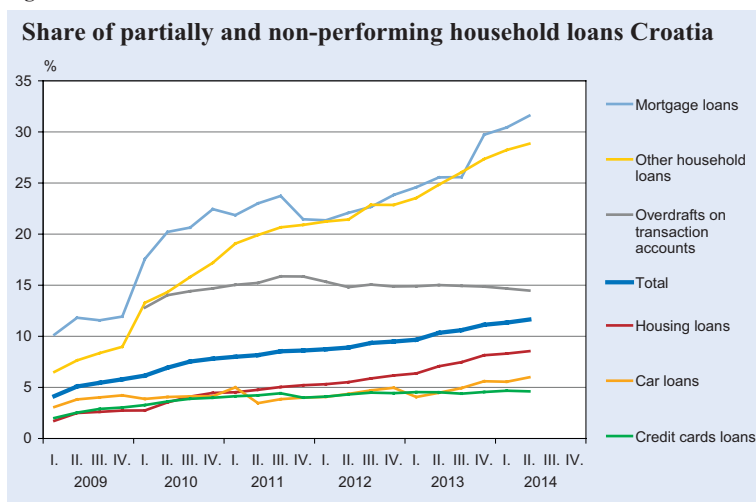


Figure 2



value of Swiss franc-loans, by temporarily imposing a fixed kuna-Swiss franc exchange rate on existing loans (Government of Croatia 2015b). Furthermore, other *ad-hoc* measures are being discussed in Croatia and elsewhere in the region, in particular a permanent conversion of all foreign-currency mortgage loans to local currency following the Hungarian example.

Other European governments have intervened in the past years, mainly due to non-existing or non-sufficient consumer bankruptcy laws and the fear of broader side effects on the financial sector and the whole economy. Experience shows that direct government support may be needed in cases where the debt overhang is so severe and widespread that market mechanisms no longer work and/or financial stability is at risk (see e.g. the case of Iceland; Liu and Rosenberg 2013). But generally speaking, temporary measures by the government can be criticized as interfering with private contracts and undermining credit discipline. They damage the rule of law, may endanger the independence of judiciary, and raise the problem of moral hazard (Liu and Rosenberg 2013). They therefore may give negative incentives for private households to continue incurring excessive debt, and for banks to promote loans in foreign currencies.

Consumer bankruptcy laws

Theoretical background

A personal bankruptcy law aims to establish an even, predictable burden-sharing between borrower and lender. It should make it possible for the private person to get a 'fresh start' after completing a certain pe-

riod of repayments, rehabilitating her afterwards by clearing the un-payable remaining debts (Christopherson and Abjornsson 2011). On the other hand, it should maintain credit discipline and prevent moral hazard. As a result, many countries have changed their stance, from one in which only lenders are responsible for their debts and where contracts have to be complied with, to a view where the creditors are also responsible for the over-indebtedness of the households mainly because of loose lending policies.

The rehabilitation of the debtor slid into the main focus when new consumer insolvency laws were being devised in recent years.

In general there are two different models of consumer bankruptcy, the Anglo-Saxon and the continental European models. The first stands for a liberal 'fresh start' policy and is common in the United States, Canada, Britain and Commonwealth countries. It is referred to as a 'fresh start' system since debtors can discharge their debt via bankruptcy and continue their lives free of their previously existing debt without the need to fulfill a 'payment plan' over a certain time period (Ramsay 2012). The continental approach, in turn, consists of a long-lasting procedure that allows for a fresh start only after a period of distress and sanction ('earned start'). Consumer bankruptcy regulations structure consumer's debt repayments and limit the amount of earnings that can be used for the individual's living. Laws within the Continental approach mainly differ regarding the duration of the repayment and recuperation process.

Status quo in Croatia

Croatia's current insolvency regime only covers the bankruptcy of corporations and not that of individuals – the institutions of personal bankruptcy and debt rescheduling for the over-indebted do not exist. The missing legal framework has become a problem in the past years as the total indebtedness of the private households grew and the number of insolvent households with blocked bank accounts increased.

In response, the government passed several *ad-hoc* measures, while a draft for a consumer bankruptcy

law (Draft of the Consumer Bankruptcy Law Proposal, Ministry of Justice, June 2014), modeled on the German approach, is currently under examination (Bodul and Žiković 2014). On 13 March 2015 the Croatian government endorsed the consumer bankruptcy bill. According to the government, the bill includes the following measures: a debtor will first have to try to settle with the creditor out of court, under the aegis of a Financial Agency advisory body. If no agreement is attained, the proceedings will continue in court. If no court settlement is reached, the court will then appoint a trustee to divide the consumer's estate. Debts would be written off only for debtors without assets or job prospects, while employed debtors would retain income only for the bare necessities, the rest going towards paying off their debts. Consumers who file for bankruptcy will have to report to the trustee any changes to their assets for a period ranging from one to five years. Filing for bankruptcy will be possible to all insolvent consumers with debts exceeding 30,000 kunas if they have been unable to serve their debts for three consecutive months (Government of Croatia 2015c).

Latvia's new consumer bankruptcy law

During the boom years (2000–2007), Latvia's non-financial private sector debts, held predominantly in foreign currencies, increased rapidly. While real GDP grew by an average of 10.3 percent annually between 2005 and 2007, external debt did so by 172 percent, reaching 128 percent of GDP. When the financial crisis hit in 2008/09, debt restructuring became unavoidable. The restructuring was in part done by the foreign banks in Latvia, which had the necessary resources for the purpose. The Latvian government, in turn, chose a market-based approach to restructure the debts, preferring the provision of a sufficient legal framework over direct public intervention.

Firstly, amendments to tax legislation were introduced to give incentives for debt forgiveness. For instance, the transfer of a distressed loan to a third party was declared a tax-neutral event. Secondly, incentives for voluntary out-of-court debt restructuring were set in order to relieve the courts and make the process of restructuring speedy, cost-effective and flexible. Thirdly, in 2009 amendments to the insolvency law were made to allow the rehabilitation of viable firms and the liquidation of non-viable firms.

Furthermore, a new personal insolvency law was adopted in 2010 to provide indebted individuals with the possibility of an exit and of avoiding over-indebtedness, providing financially responsible individual debtors with a fresh start at the end of their insolvency proceedings. The repayment plan lasts between 1 year and 3.5 years, depending on how much the debtor is able to repay of the remaining obligations. Further recommendations to the legislation are the strengthening of the court system and amendments to the Civil Procedure Law (Erbenova, Liu and Saxegaard 2011).

Policy proposals

Private bankruptcy legislation

Taking a leaf from the Latvian example, the best way to deal with private household debt is *via* a consumer bankruptcy law that gives individuals and micro-enterprises the possibility to restructure their debts and make a fresh start. With a view to forestalling bankruptcy tourism (Hoffmann 2012) and considering the general alignment of rules and laws within the European Union, we propose for Croatia to follow the continental European approach for a consumer bankruptcy law. Based on the experience with existing private bankruptcy laws in Europe, a maximum repayment period of 3 to 5 years is advisable, with 5 years being considered more debtor-friendly and shorter periods more creditor-friendly. We advise against regulations stipulating that filing for bankruptcy is permitted only above a given amount of debt (see Government of Croatia 2015c – new bill on personal bankruptcy in Croatia stipulates that filing for bankruptcy will only be possible if debts exceed 30,000 kunas).

The implementation of a new law needs to be embedded in the institutional infrastructure, including the availability and quality of judges and trustees, administrative capacity, accounting, and valuation systems. In order not to put undue stress upon the existing legal institutions, out-of-court settlements must be encouraged as well, which can take the form of voluntary arrangements between the lender and the borrower consisting of a binding and formal arrangement under which creditors may agree to accept less than the full amount they are owed, usually paid over a period of three to five years, or introducing third-party payments.

Preventing consumer insolvency

(1) Consumer protection

Croatia should follow the European Commission's proposal for legislation on 'responsible lending and borrowing' on mortgages, which includes a range of preventive measures such as requiring a standardized pre-contractual information sheet, having a mandated period where the borrower has the right to withdraw, regulating advertisement, and verifying creditworthiness (European Commission 2011 and 2013). The European Systemic Risk Board (ESRB) also published recommendations in 2011 covering the granting of foreign-currency loans, recommending that the national supervisory authorities and EU member states require their financial institutions to provide borrowers with adequate information regarding the risks involved in foreign-currency lending and also, if necessary, directly limit the amount of lending in foreign currencies (ESRB 2011).

The following measures should accompany a law on consumer bankruptcy, aimed at preventing consumer insolvency:

- Bank customers must consult guidelines provided by banks/national authorities to inform themselves about possible risks of their loans, in particular the exchange-rate risks associated with loans denominated in a foreign currency²
- Banks can be recommended to offer financial instruments to hedge against the exchange-rate risk associated with loans in foreign currencies
- Debt counselling and financial education for individuals
- A credit registry for private consumers providing banks and businesses with information about the creditworthiness of borrowers.

(2) Risk management for the banking sector

The ESRB has also made recommendations concerning the risk management of financial institutions, asking the national supervisory authorities mainly to monitor levels of foreign-currency lending and to allow foreign-currency loans to be granted only to bor-

rowers with sufficient creditworthiness (ESRB 2011). The Croatian National Bank has been using a variety of measures since 2003 to slow credit growth, especially in foreign currencies, including higher reserve requirements and higher risk weights for unhedged foreign currency loans, as well as measures like ceilings on credit growth, marginal reserve requirements on foreign borrowing, and foreign currency liquidity requirements (Murgasova and Rahman 2012). But success has been modest, especially as regards loans to Croatian corporations, since foreign parent banks extended credit directly to the customers; the scant success may also be due to the fact that banks did not take account of the regulations.

A national supervisory authority should stipulate the measures to be adopted by the different financial institutions, which include:

- Furthering the implementation of the Basel III and EU Capital Requirements Directive IV/Capital Requirements Regulation (CRD IV/CRR)
- Incorporating foreign-currency lending risks in banks' internal risk management systems
- Stricter lending policies for loans in foreign currencies, especially for unhedged households
- Stress tests for banks in order to check stability and to quantify the effects of economic changes on the borrower's solvency

Conclusion

No further state interventions or *ad-hoc* measures are recommended, since they severely interfere with legal certainty and the rule of law. Instead, the introduction of a consumer bankruptcy law, measures to prevent unsustainable household indebtedness and risk management tools on the banking side are strongly recommended. In particular, loose credit regulations should be tightened and loans denominated in foreign currencies should be hedged.

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² For an example of a customer consulting guideline on foreign currency loans, see <http://oenb.at/dms/oenb/Finanzmarktstabilitaet/Downloads/Systemrisikoanalyse/Fremdw-hrungs--und-Tilgungstr-gerkredite/Folder-Fremdwaehrungskredite/Folder%20Fremdw%C3%A4hrungskredite.pdf>.

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