Conversion of Foreign Currency Loans in the CEECs

Zsuzsanna Novák
Magyar Nemzeti Bank, Hungary
Imre Vámos
Óbuda University, Hungary

Abstract

Between 2004 and 2008 low-interest foreign currency based loans, and above all household loans, became more and more popular in Central European countries like Croatia, Hungary, Poland, Romania and the Baltic countries in an environment of high and volatile inflation but stabilising and in some cases appreciating exchange rate. (Király–Simonovits, 2015) The stable outlook for the exchange rate was further strengthened by the prospect of euro adoption. When the global financial crisis hit Europe, however, Central European economies went under a strong currency depreciation and decline in income, interest and principal payments put a much greater burden on debtors than previously. The situation was further deteriorated by the decision of the Swiss National Bank to abandon the cap of its currency's value against the euro. After the comparison of the extent of depreciation and the dynamics of household FX loans based on central bank data, the paper examines the economic policy measures taken by Croatia, Hungary, Poland and Romania to protect debtors from the increasing debt burden with special emphasis on the leading role of the Central Bank of Hungary (MNB) having been widely acknowledged by international organisations (IMF, 2016, European Commisson, 2016a).

Keywords: foreign currency loans, exchange rate risk, conversion, macroprudential measures and central bank instruments
JEL classification: E65

Introduction

The excessive demand for foreign currency loans in the CEECs before the global financial crisis was not an unprecedented phenomenon. Foreign currency loans among commercial debt obligations extended by foreign banks also contributed to the Latin American debt crisis of the 1980's (A. Cavallo–Fernández-Arias, 2013) and dollarised (euroised) countries have often relied on FX resources ever since. Foreign currency debt amounts to some 10% of non-financial sector loans provided by resident financial institutions also in the euro area (Ongena et al., 2014). The dynamics of foreign currency lending to households in the CEECs in the years 2004-2008, however, has exceeded the pace ever recorded in Europe. These countries with the full liberalisation of the capital accounts attracted cross-border capital inflows and banking operations which at the same time restricted preventive policy actions. The paper examines the dynamics and costs of foreign currency lending and the macroprudential measures of the selected countries as responses to the problem.

Among the reasons for this proliferation of FX financing in the region, the volatility of the domestic inflation and the relatively stable exchange rate of the domestic currency (Király–Simonovits, 2015), the relatively low foreign currency interest rate (European Commission, 2016b) and interest volatility (Schepp–Pitz, 2013) it entailed, the loan supply boom it triggers (Király–Simonovits, 2015) and the restrictive monetary policy accounting for the relatively high domestic interest rates creating a permanent advantage of FX loans compared to domestic currency loans (Brzoza–Brzezina et al., 2010) were highlighted in the literature. Interest parity conditions were either disregarded by borrowers of such loans or, as Király and Simonovits (2015) suggest, the prospect of eurozone membership meant such stability for the domestic currency that no depreciation equivalent to the interest rate differential was expected. Furthermore, Király and Simonovits (2015) emphasise two further factors which prevent the interest rate parity condition to be satisfied: on the one hand, foreign currency premium may prevail for a long term due to country-specific risk, on the other hand, term premia materialising between different maturities might also persistently allow a less strong depreciation than the interest rate parity condition would require. This altogether strengthened the attractiveness of FX loans and even pushed some investors to get involved in speculative carry trade activity. Foreign currency lending was also boosted by the often loose lending policy of banks. (Bierut et al., 2015)

Substitution of domestic and foreign currency loans constrains monetary policy in materially influencing the volume of credit in the economy and in providing financial stability making the credit and interest rate channel of monetary policy less effective, distorting information on monetary and credit aggregates which are important to assess real and nominal developments even in an inflation targeting environment. (Brzoza–Brzezina et al., 2010). In addition it entails substantial risks, first of all exchange rate risk, which turns to credit risk in case of a significant depreciation of the domestic currency and worsening of the income situation of borrowers. In many countries FX loan borrowers had no natural hedge – that is assets producing foreign currency income or wage income in foreign currency – which could have helped them manage FX exposure. Though the depreciation shock hitting households did not necessarily erode the welfare advantage of foreign currency debtors compared to domestic currency debtors, as the interest and principal payment slipped, or even multiplicated, the number of debtors with payment difficulties and the volume of the non-performing loan portfolio of banks started to soar. The increase in NPL ratios together with increasing real estate prices and reliance on foreign financing can lead to systemic risk (Bierut et al., 2015) stimulating the supervisory authority and finally central banks to take preventive or corrective measures to protect financial stability. Moreover, credit institutions only partly covered their open positions with foreign liabilities, they often resorted to the derivatives market – FX swap and CIRS – to hedge their FX exposure and when implied foreign currency interest rates increased, they had to face increased rollover costs posing further risk to the banking system.

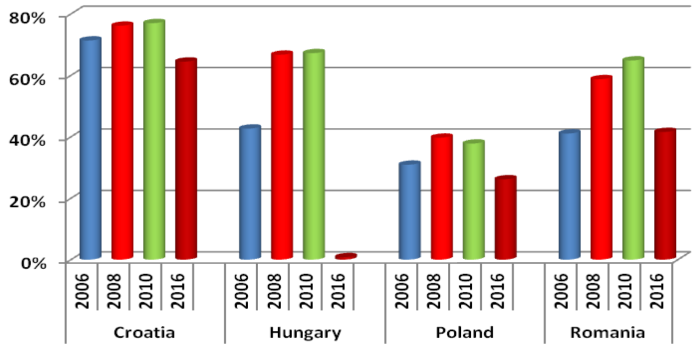
Methodology

The foreign currency loan accumulation and its consequences in Croatia, Hungary, Poland and Romania is discussed with the help of literature survey and descriptive data analysis mainly based on central bank studies and data supplemented with information from the IMF, the European Mortgage Federation and other international organisations,

Results

Due to the excessive foreign currency lending dynamics in the household sector (reaching a 5-10% monthly nominal growth in Hungary and 2-6% in Poland between 2005 and 2009, and around 6% in Romania in 2007-2008), the share of foreign currency loans in the total household loan portfolio of Hungary, Poland and Romania sharply increased especially after 2005 and only regulatory measures after the crisis could suppress this share to or under pre-crisis levels. (Figure 1) Within this foreign currency loan portfolio especially CHF-denominated mortgage loans carried high risk due to their rapid accumulation, and thus high weight and often poor quality. Due to historical reasons – repatriation of foreign income in war times – Croatia has been characterised by a high level of euroisation which thanks to regulatory changes – e.g. closing the gap between reserve requirement on kuna and foreign currency liabilities – seemed to come to a hault and accelerated again after the outbreak of the global financial crisis. (Galac, 2012). In Croatia the measures taken to mitigate systemic risk were partly also aimed at the de-euroisation of the economy. Moreover, in Hungary an almost complete meltdown of household FX loans can be observable after 2015 as a result of policy commitment to the entire phasing out of such loans.

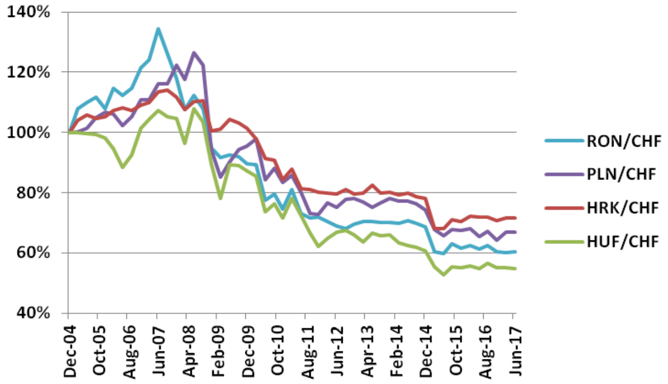
Figure 1
Foreign currency household loans to total household loans



Source: MNB, NBP, NBR, IMF, own illustration
Note: In the case of Hungary data cover the whole household sector, whereas in Poland and Romania data refer to credit by MFIs and Croatian data had to be substituted with total loans of the economy without sectoral breakdown from the IMF FSI database. The latter seemed to be a good approximation compared to some available annual data from credit institutions' non-consolidated balance sheet.

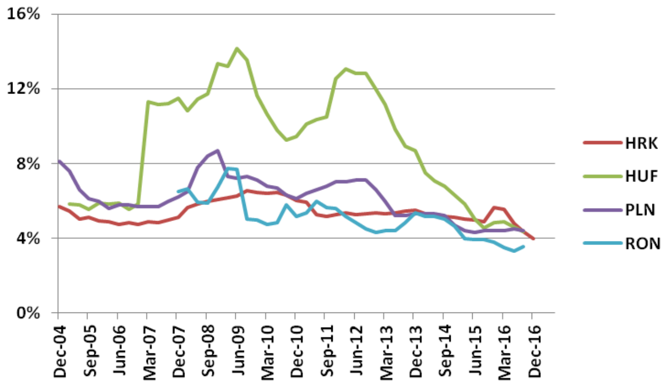
The enhanced cost of foreign currency loans can be best illustrated by the abrupt depreciation of domestic currencies against the Swiss franc from the second half of 2008 which continued at a lower but persistent pace until the unpegging of the Swiss franc in January 2015 which caused a one-time drop again (Figure 2). The Hungarian forint went under the most significant weakening, it lost some 40% of its end-of-2004 value by 2015, at the same time causing the greatest increase in the debt burden of borrowers. As regards interest payments, comparing average interest rates on mortgage loans (Figure 3) one can easily conclude that again Hungarian debtors were the most affected by the worsening economic outlook and escalating risk exposure. According to Schepp and Pitz (2013) the reason for the spectacular increase in loan interest rates in Hungary lay in the growing CDS spreads, the deteriorating asset quality of the banking sector and also extra government levies on financial institutions which caused a broadening premium compared to the CHF interbank reference rates as basis price for foreign currency funding.

Figure 2
Currency exchange rates against Swiss franc between 2005-2016 (December 2014=100%)



Source: Stooq, own illustration

Figure 3
Annual weighted average mortgage loan interest rates (2005-2016)



Source: European Mortgage Federation, CNB
Note: In the absence of comparable data in the case of Croatia, the CNB's annual average household housing FX- indexed loan interest rates were used (FX-indexed loans account for some 80-90 per cent of all home and mortgage loans).

Discussion

Some macroprudential policy responses in the CEECs

As the crisis hit the central and eastern part of Europe causing significant currency depreciation and fall in (real) income it became evident that the previously accumulated FX loans – especially those taken by households – bears a significant risk which might jeopardise financial stability. Monetary and supervisory authorities in the region started taking measures to tackle the problem of foreign currency loans, they issued recommendations or co-operated with the legislation.

Without aiming to give an all exhaustive list of measures taken by Central and Eastern European authorities, some important elements of their intervention is worth emphasising. From as early as 2005 the National Bank of Romania started imposing additional lending requirements on credit institutions, which in 2008 were made more severe as regards loans granted in a currency different from the currency in which the borrower earned its wage income. In addition, in 2008 lending norms had to be amended to take account of the materialisation of exchange rate and interest rate risk or a substantial change in the fees and commissions charged by credit institutions. The NBR constantly issued public warnings – e. g. in the Financial Stability Reports – regarding FX loans with special emphasis on CHF denominated loans. In Romania the recommendations of the European Systemic Risk Board (ESRB) on lending in foreign currencies (2011) were also incorporated in the national legislation by establishing maximum indebtedness level for consumer loans, imposing collateral thresholds and capping on LTV ratios. (NBR, 2015) The NBR also resorted to traditional measures, such as changing the reserve requirement on FX liabilities to forego potential risk to financial stability arising from FX loans. Overall, the prudential measures taken in Romania were acknowledged by international organisations (e. g. IMF, see Jácome and Mitra, 2015).

In Hungary the central bank played an active role above all by supporting the policy of the government in the different periods of phasing out FX loans from participating in the legal preparatory activity to holding foreign exchange tenders for banks. At the MNB's initiative, in 2009 a government decree on the conditions of prudent retail lending and the examination of creditworthiness set limits to FX lending by maximising loan-to-value ratios and specifying requirements concerning the debtor's income situation supplemented by a decree of the governor of the MNB further restricting LTV and PTI ratios in the case of consumer loans. In 2011 financial regulations were amended in connection with the restriction of credit interest rates and for ensuring transparent pricing mechanisms with special regard to mortgage loans requiring that such loans have to bear either fixed interest rate or be linked to a variable reference rate. This was followed by a new act on „fair banking" entering into effect in 2015 which stipulated conditions to be considered when modifying the interest rate applied. There were a lot of efforts made to rescue late-paying borrowers through, among others, the introduction of exchange rate cap. In addition, under very strict circumstances FX loans could be converted into forint on request until May 2012, and FX borrowers could also participate in the early repayment of loans in which the Central Bank of Hungary provided credit institutions with the foreign currency necessary for refunding their foreign currency liabilities. (MNB, 2012)

Primarily due to the sharp increase in FX loans, especially in mortgage lending, Poland also introduced stricter prudential regulations. It raised the minimum risk weight for FX mortgage loans in 2007 and then again in 2012. (Jácome–Mitra, 2015) Polish banking regulators also issued recommendations to improve credit risk management. The outright legal ban on FX loans was also considered in Poland, but finally regulators rather squeezed lenders by moral suasion to put an end to FX mortgage lending. Credit risk management was strengthened through numerous regulations capping DTI and LTV ratios or obliging banks to establish own DTI limits and requiring stricter creditworthiness analysis. As these decisions were made by the supervisory authority (PSBA), the National Bank of Poland could influence these processes mostly as an advisor and by constantly monitoring systemic risk. The measures helped curbing and finally eliminating the extensive demand for FX mortgage loans. (Bierut et al., 2012)

In Croatia the central bank first of all concentrated on keeping a stable exchange rate because of the historically high, almost three-fourth ratio of FX loans in total loans. The negative tendency in the payment discipline in the FX loan market lead to launching more stringent regulations in the field of provisioning requirements and the

capital requirement was raised concerning banks' currency-induced credit risk, the risk weight for FX loans for unhedged clients exposed to foreign currency risk was lifted. (Brown-de Haas, 2010) The CNB also required banks to purchase CNB bills in proportion to excess credit growth in the crisis years and later increased capital adequacy requirements simultaneously with the removal of higher risk weights on FX loans in 2010. In 2015 the CNB obliged banks to inform consumers about interest and currency exposure by calculating monthly instalments and offer a domestic currency credit equivalent as their own product or of other banks. (Vujčić–Dumičić, 2015)
Overall it was a general practice in these countries to consult with the financial industry when drafting new prudential measures and modifying existing regulations. The ESRB issuing new recommendations in 2011 on lending in foreign currencies built upon the principle of resciprocity (obliged EU countries to respect the relevant measures introduced by other EU authorities) also helped to partly avoid unadvertently benefiting companies applying regulatory arbitrage. (Bierut et al., 2012)

Conversion of FX loans into domestic currency

As seen in the comparative statistics, Croatia and Hungary had to face the greatest challenge in managing households' foreign currency indebtedness. The other two countries, Poland and Romania did not convert household FX loans into domestic loans even after the abolition of the CHF exchange rate cap causing sharp depreciation of Central European currencies against Swiss franc. It was a lingering issue in Poland but finally the Parliament only discussed bills on consumer compensation and on the optional solution for banks to convert FX loans. In Romania the Parliament approved a bill on the opportunity of consumers to convert Swiss franc loans into lei at the initial exchange rate but finally the constitutional court refused it. In Hungary the severity of the situation of FX loan holders can be best characterised by the decision of lawmakers to compensate households for some extra costs unfairly charged by credit institutions and a full phasing out of FX loans. The MNB assumed a great role in the settlement of household FX loans arising from the unfair use of exchange rate spread and the contractual clause on unilateral contract amendment of consumer loan agreements and the forint conversion of these loans by providing the amount of the foreign currency needed to cover banks' hedging requirement in the form of euro sale tenders in 2014 and 2015 for household mortgage loans and Swiss franc sale tenders for the remaining consumer FX loans in 2015. The foreign currency purchased in the MNB tenders by credit institutions was rolled over in FX swaps or combined with an opposite CIRS transaction, except those banks which directly purchased the euro or CHF without rolling it over. The whole household FX loan stock that was affected by the conversion amounted to approximately EUR 11-12 billion, whereas banks purchased foreign currency at a volume of some EUR 9.6 billion from the MNB (Matolcsy-Palotai, 2016). Some of the transactions were bound to the condition of reducing short-term liabilities of banks. Partly for the burden on households it released and the timing of the forint conversion of FX loans (preceding the decision of the Swiss National Bank), Hungary's efforts to stabilise the economy were widely acknowledged by international institutions (IMF, 2016, European Commisson, 2016a).

As legislation in Croatia enacted the law on the conversion of Swiss franc-indexed loans to euro (Act on the Amendments to the Consumer Credit Act) and the partial write-off such loans, the Croatian National Bank adjusted its monetary policy to ensure foreign currency liquidity for banks by intervening in the foreign exchange markets in September 2015. (CNB, 2016) (In December 2015, EUR 275 million worth of household loans indexed to Swiss franc were converted into euro loans and EUR 130 million worth of loans were written off.) To make up for shrinking domestic currency liquidity the CNB also renounced compulsory CNB bill sales and provided banks with liquidity by conducting reverse repo operations. With these steps the CNB avoided and undesirable depreciation of the domestic currency and a possible liquidity shortage in the banking system. Thanks to banks' deleveraging their foreign currency denominated assets exceeded their liabilities for the first time since 2002 (CNB, 2016).

Conclusion

Foreign currency and foreign currency-indexed household loans became extremely popular in the CEECs preceding the 2008 global financial crisis primarily due to their low interest rates and the domestic currency's stability expected to be a long term phenomenon. The crisis, however, eroded the great part of the advantages of such loans. After a lot of measures aimed at easing the burden on households, Hungarian authorities decided to phase out household FX loans entirely. The way of conversion of household FX loans into domestic currency can be said to be the most elaborate among all the Central and Eastern European Countries and the timing was also lucky as it preceded the abolition of the Swiss franc cap. Partial conversion of FX-indexed loans also took place in Croatia, whereas Poland and Romania did not resort to such direct action, but in these countries a wide range of macroprudential measures have been taken even before the outbreak of the crisis.

References

1. Bierut, B.–Chmielewski, T.–Głogowski, A.–Stopczyński, A.–Zajączkowski, S. (2012), "Implementing Loan-To-Value and Debt-To-Income ratios: Learning from country experiences, The case of Poland", NBP Working Paper No. 212, Economic Institute, Warsaw. available at: https://www.nbp.pl/publikacje/materialy_i_studia/212_en.pdf (12 March 2017)
2. Brown, M.–De Haas, R. (2010), "Foreign currency lending in emerging Europe: bank-level evidence. European Bank for Reconstruction and Development", Working Paper No. 122, available at: http://www.ebrd.com/downloads/research/economics/workingpapers/wp0122.pdf (22 April 2017)
3. Brzoza-Brzezina, M.–Chmielewski, T.–Niedźwiedzińska, J. (2010), "Substitution between domestic and foreign currency loans in central Europe. Do central banks matter?" ECB, Working Paper Series, No. 1187, pp. 36-42.
4. Cavallo, E., Fernández-Arias, E. (2013), "Coping with Financial Crises: Latin American Answers to European Questions", International Development Policy, Graduate Institute of International and Development Studies, 4.2/2013, pp. 7-28. available at: https://poldev.revues.org/1252 (13 April 2017)
5. Croatian National Bank (CNR) (2016), "Annual report 2015", Zagreb. available at: https://www.hnb.hr/en/analyses-and-publications/regular-publications/annual-report (13 April 2017)
6. European Commission (2016b), "Statement at the European Parliament on Foreign Currency Loans. Lord Hill's reply in the European Parliament on 12th May 2016 to oral Question 37/2016 on Foreign Currency Loans", available at: https://ec.europa.eu/commission/commissioners/2014-2019/hill/announcements/statement-european-parliament-foreign-currency-loans_en (13 April 2017)
7. European Commisson (2016a), "Country Report Hungary 2016. Including an In-Depth Review on the prevention and correction of macroeconomic imbalances", COMMISSION STAFF WORKING DOCUMENT. available at: http://ec.europa.eu/europe2020/pdf/csr2016/cr2016_hungary_en.pdf (13 April 2017)

8. Galac, T. (2012), "Global Crisis and Credit Euroisation in Croatia. Croatian National Bank", Working Paper W-33, Zagreb, January. available at: https://www.hnb.hr/documents/20182/121363/w-033.pdf/595ef2d7-22df-4cad-8217-baf266255e3b (13 March 2017)
9. IMF (2016), "2016 ARTICLE IV CONSULTATION—PRESS RELEASE; STAFF REPORT; AND STATEMENT BY THE EXECUTIVE DIRECTOR FOR HUNGARY", available at: http://www.imf.org/external/pubs/ft/scr/2016/cr16107.pdf (7 March 2017)
10. Jácome, L. I., Mitra, S. (2015), "LTV and DTI Limits–Going Granular", IMF Working Paper, 15/154.
11. Király, J.–Simonovits, A. (2015): "Jelzáloghitel-törlesztés forintban és devizában – egyszerű modellek" (Mortgages denominated in domestic and foreign currencies: simple models), Közgazdasági Szemle, LXII/1, pp. 1-26.
12. Magyar Nemzeti Bank (MNB) (2012), "Guide to the regulation concerning FX lending in Hungary", available at: http://alk.mnb.hu/data/cms2408096/ESRB_guidelines_compliance.pdf (13 April 2017)
13. Matolcsy, Gy.–Palotai, D. (2016), "The interaction between fiscal and monetary policy in Hungary over the past decade or half", Financial and Economic Review, Vol. 15 No 2, pp. 5–32.
14. National Bank of Romania (NBR) (2015), "Analysis on CHF-denominated loans", February, available at: http://www.bnr.ro/Studies-3215.aspx (3 April 2017)
15. Ongena, S.–Schindele, I., Vonnák, D. (2014), "In Lands of Foreign Currency Credit, Bank Lending Channels Run Through? The Effects of Monetary Policy at Home and Abroad on the Currency Denomination of the Supply of Credit", Centre for Economic and Regional Studies, Hungarian Academy of Sciences, MT-DP-2014/24, pp. 52, available at: http://econ.core.hu/file/download/mtdp/MTDP1424.pdf (5 April 2017)
16. Schepp, Z., Pitz, M. (2013), "Determinants of the Pricing of Bank Loans: a Structural VAR Based analysis", Public Finance Quarterly, 2013/4, pp. 420-433.
17. Vujčić, B.–Dumičić, M. (2015), "Managing systemic risks in the Croatian economy", BIS Papers, No 86, available at: http://www.bis.org/publ/bppdf/bispap86l.pdf (13 April 2017)

About the authors

Zsuzsanna Novák, Ph.D. is an analyst at the MNB (Central Bank of Hungary), Directorate Monetary Policy Instruments, Foreign Exchange Reserves and Risk Management. She received PhD in Management and Business Administration at the Institute of Economics of the Szent István University, Gödöllő with the dissertation thesis "Some coherence between economic convergence and monetary policy". She participated in CEEPUS academic mobility program at the University of Zagreb. Her main research interests are monetary policy, economic convergence, public debt and equilibrium exchange rates. Author can be contacted at **novakzs@mnb.hu**.

Imre Vámos, is a lecturer at the Óbuda University, Keleti Faculty of Business and Management and auditor at the State Audit Office of Hungary. His main research interests are stock prices, equilibrium exchange rates and corporate and government accounting. Imre Vámos published several scientific papers in international and national journals and participated in many scientific international conferences, among others those organised by the University of Dubrovnik. Author can be contacted at **vamosz@vipmail.hu**.