Foreign currency loan dependency and consolidation

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The authors present and address in depth one of the most debated and sensitive topics of our time, which affects hundreds of thousands of bank customers, both retail and municipal: foreign currency lending and the increasing repayment difficulties associated with such loans. Unsatisfactory supervisory regulation and oversight, financial institutions' economically unfounded credit expansion and debtors' reckless borrowing all played a part in this, albeit to somewhat different degrees. Addressing the resulting adverse consequences has become an important state (fiscal) and monetary task. The authors of the monograph present their views on the resolution of this task and formulate recommendations factoring in public finance, legal and European Union considerations. The editor posits that the Hungarian population's foreign currency loan problem cannot be interpreted without taking into consideration the broader international and historic context *(Lentner, 2015)*.

The volume is presented by topic, rather than by chapter, moving in the order of the developments, starting from the historical antecedents through to the measures to find a solution.

Government and household indebtedness was already a common phenomenon in post-Trianon Hungary, as the newly established MNB was compelled to adapt to the elevated interest rate on the League of Nations loans, making Hungarian credit demand attractive

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for foreign capital. Profitability conditions, however, did not allow for realistic returns, and thus debtors used short-term loans to finance long-term objectives, which rendered realistic returns unfeasible to begin with. The credit market collapsed during the 1929–33 crisis, and the MNB introduced foreign exchange management, announced a moratorium on transfers and began gradually cutting the key policy rate to 4.5 per cent *(Schlett, 2015)*.

The Governor of the MNB, *György Matolcsy*, argues that the current spread of foreign currency lending created severe economic and social woes by the end of the 2000s, woes that can only be eradicated gradually and at a high cost. The spread of this practice was fostered, alongside reasons of credit demand and supply, not only by economic policy decisions and mistakes, but also by lacunae in financial literacy and lack of knowledge about exchange rate risks. As foreign currency indebtedness affected almost all participants in the economy, it grew into a national issue. Identifying the negative consequences is a serious challenge for the state. The necessary series of measures began with the prohibition of registering mortgages, putting an end to foreign currency lending. Subsequently, the exchange rate cap allowed debtors to repay their foreign currency loans at preferential exchange rates for a period of five years and to benefit from ongoing support in the interest of phasing out foreign currency lending *(Matolcsy, 2015).*

The far lower interest rates on foreign currency loans compared to forint loans at the time undoubtedly made them attractive. In the early 2000s, the interest rate on the Swiss franc barely changed and the population did not expect any significant exchange rate volatility. However, the 2008 financial crisis triggered drastic changes and the forint quickly depreciated by almost 40 per cent against the Swiss franc. This came as a surprise compared to the abundant supply of funding and liquidity that had prevailed before the crisis.

Meanwhile, the expansionary fiscal policy, the lack of necessary capital market knowledge, the uncertainties in the regulatory environment and the indecisiveness of Hungarian economic policy all rendered Hungary more vulnerable.

Economic policy began to curb the further spread of foreign currency lending in 2010. The first measures to be implemented were aimed at reducing government debt and scaling back and discontinuing foreign currency lending. These included early final repayment at preferential exchange rates, a moratorium on evictions and discounted home rental schemes.

Hungary's external balance, current account and trade balance improved and banks' external debt volume shrank in the wake of these measures. This decreased Hungary's external vulnerability, bolstered its foreign exchange reserves and boosted central bank profits, ensuring the sustainability of the external balance over the longer run *(Erhart et al., 2015).*

Taking a slightly different approach, the difficulties arising from foreign currency household lending were triggered by a combination of an excessively expansive fiscal policy and a quite restrictive monetary policy. Members of the Financial Stability Committee set up in 2004 (the MNB, the Ministry of Finance, the Banking Supervisory Authority) had diverging assessments of the situation, preventing consensus-based decisions at a time when the appointment of a responsible macroprudential authority would have been much needed.

As Hungarian banks' strategy was based on rapid volume growth, they often turned a blind eye to considerations of risk. Exchange rate risk, however, became an increasing concern, but this risk was passed on to customers. The fact that interest conditions were not clearly defined paved the way for unethical interest rate hikes. The risk management methods applied were thus often unsuitable for measuring the actual extent of risks; confidence in the system of financial intermediation was shaken and became a broad social issue *(Bethlendi et al., 2015).*

Foreign currency borrowing was and continues to be a source of problems, not only for households, but for local governments as well, although several European countries prohibit the latter from taking out working capital loans, even if certain investments are essential. In Hungary, this restriction is opposed from several aspects, as it fails to take into account the diverging nature of operating and development objectives, the size of local governments and overplanned appropriations.

At the same time, local governments are often bound to loans without having duly taken into consideration the burdens incurred by them or the funds for repayment. The National Assembly passed new legislation on local governments in 2011, which reorganised local government functions and introduced a function-based funding system. As a result, not only did local governments' outstanding debt shrink, the new legislation significantly approached European practice *(Gregóczki, 2015).*

The impact of foreign currency mortgage lending (housing finance) on financial stability differs across countries of varying degrees of development, although its nature and share is not a function of a country's level of development, but much rather of its financial stability. The main participation criteria are: *(i)* the homes must be affordable; *(ii)* they must have the direct and indirect institutions necessary for construction; *(iii)* adequate supervisory and regulatory structure must be in place; *(iv)* own homes should qualify for tax allowances; and *(v)* in other places, the construction of homes for rent are preferred (for instance the Federal Republic of Germany).

The crisis led to a deterioration in loan payment discipline and eroded trust in the financial sector even in advanced economies. Reckless lending and borrowing triggered serious consequences in the developed world as well.

The Financial Stability Council was called into existence by the new central bank act in 2013 to monitor the stability of the system of financial intermediation and markets, any

emerging risk factors, the pertaining recommendations of EU authorities, developments in creditworthiness criteria, etc.

Stemming from the foregoing, earlier housing finance decisions must be reviewed, including the application of more affordable lease conditions for low income households, etc. A rule adjusting borrowing and repayment to legal income effective as of 1 January 2015 serves this purpose. The past decade has seen a marked shift between households' funds (cash + deposits) and their outstanding borrowing, with the latter swelling in size. Certain years even saw households' outstanding borrowing outstrip their funds (cash + deposits). The situation not only negatively impacted foreign currency indebtedness, but also households' liquidity position. Although the government tried to alleviate the situation with the fixed exchange rate, various emergency measures, the National Asset Management Agency, early final repayment and an agreement with the Banking Association, and to reduce the ratio of foreign currency loans, the banking system, the Banking Supervisory Authority and the central bank should have identified the problems earlier *(Novoszáth, 2015).*

Foreign currency lending spread not only in Hungary, but in other Central and Eastern European countries as well, although the issues were addressed differently from one country to the next. While the difference between low interest rates on euro-denominated loans and the national currency was substantial in Poland, Hungary and Romania, the stock of foreign currency loans shrank substantially in Slovakia and Slovenia once they had introduced the euro, with this development mainly driven by corporations. In the Czech Republic, the central bank limited foreign currency lending to corporations only.

Finally, the EU also saw a need to reform the banking sector by establishing the European Systemic Risk Board (ESRB), the European System of Financial Supervisors and the Banking Union, elevating risk management to the international scale alongside the national scale *(Buda, 2015).*

The textbook shares broad-ranging knowledge not limited to educational use, but also of relevance to professionals and people interested in the subject.

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