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Systemically into the Same Puddle – Foreign Currency Lending from Several Perspectives*

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Balázs Bodzási (editor):
Devizahitelezés Magyarországon – A devizahitelezés jogi és közgazdasági elemzése (*Foreign Currency Lending in Hungary – Legal and Economic Analysis of Foreign Currency Lending*)
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Balázs Bodzási, head of department at the Corvinus University of Budapest, invited 17 experts from the banking, regulatory and legal professions to write a volume of essays, which deals with one of the key aspects of the past 15 years in Hungarian economic policy, i.e. foreign currency lending. The multi-author work examines the development of lending practices, which continue to generate heated professional and emotional disputes even 10 years after the crisis, and the economic, legal and social aftermath thereof. Although several issues were recently settled, litigations are still pending. Today, the problem is clearly no longer a financial stability issue, but rather a painful social issue, and there are many who are still "not raised by the tide", despite the economic boom.

In chapter one, entitled "*Foreign currency loans 15 years ago in Hungary", László Balogh* recalls the birth of foreign currency loans in Austria around the middle of the 1990s. Due to the presence of Austrian banks in the CEE region, the product spread rapidly with common criteria. This was also supported by the similar macroeconomic environment and business strategy characterising the region. The parent bank's liquidity and ample funding facilitated the spread of the product, offering a high margin with a low cost of funds. At the same time, the lack of households' natural hedge, as well as the plan to introduce the euro, were also common features. As a result of the permissive regulation, foreign currency lending became a systemic risk, and later – as it proved true – a social policy issue. Of the domestic triggers, the author highlights the market vacuum that developed after the termination of the state interest subsidy, which was "addressed" by foreign currency loans. He recalls the role of the Hungarian Supervisory Authority and the

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absence of its legal tools in operation at that time. Economic policy considerations “argued for” non-intervention. The author reminds the audience that it is wrong to assume that somebody “authorised” foreign currency lending, since it was the result of the foreign exchange liberalisation accompanying OECD membership and commitments to the EU. On the other hand, the asymmetric bank-client relation, the unilateral amendment of interest rates and fees, as well as the application of the exchange rate spread, were Hungarian features. Painful realisation of the systemic risk that had built up occurred with the pass-through of the economic crisis. The author reviews the legislative regulations adopted within the scope of crisis management: transformation of the Supervisory Authority, *de facto* prohibition of foreign currency retail lending and management of the outstanding portfolio, which became necessary thereafter, including the early repayment at preferential exchange rate, the exchange rate cap/overflow account schemes, the moratorium on evictions, and the National Asset Management Agency (Nemzeti Eszközkezelő – NET). The final phase-out of foreign currency retail loans and the settlement of the unfair, unilateral amendments did not take place before 2014. This was conditional on the creation of not only the legal foundations, but also the macro fundamentals. In the course of conversion into forint, the Magyar Nemzeti Bank (MNB) provided the currency necessary for conversion and supervised the settlement methodology. In 2015, both mortgage loans and unsecured loans were converted into forint, the timing of which – in the light of the Swiss central bank’s (SNB) decision – was perfect.

In the chapter entitled *“About the conversion of foreign currency loans into forint and the timing thereof”, András Becsei* also writes about this topic, among other things, recalling the agreement between the Government and the Hungarian Banking Association in November 2014, following which the Parliament adopted the act commonly referred to as the “forint conversion act”. He takes stock of the legislative decisions and the Curia decisions (unity of law resolutions) underlying the decision and details the conditions related to the economic environment: foreign exchange reserve adequacy and interest rates on loans. The conversion into forint and the settlement jointly resulted in lower instalments, decreasing credit risk and vulnerability, and thereby stronger stability. Subsequently, also considering the time of the SNB’s decision, the timing of the measures proved to be optimal. The author highlights the foreign currency sales by the MNB, as a result of which conversion was implemented in a manner that was neutral in terms of the exchange rate and the markets, as well as the potential shock that would have been caused in the debtors’ instalment and principal debt by the change in the CHF exchange rate. Finally, the lessons learnt in the region are presented in a box, coming to the conclusion that in other countries of the region the measures were less successful than in Hungary.

In the chapter entitled “*Risks of the variable and floating interest rates”, Edina Berlinger* presents – through a specific loan contract, in the form of a case study –

the practice of unilateral interest rate change and the resulting conflicts, regulatory challenges, as well as the search for solutions starting from the banking code of conduct to the regulation of settlement. The third part of the chapter analyses the present risk of variable rate loans in the new lending cycle, within the context of the regulatory environment. The author finds that the variable interest rates and the handling fees were a kind of Hungaricum. In connection with the Code of Conduct, she emphasises that it represented soft regulation, on a voluntary basis, for the banks' lending practices (pricing), the provision of information and the procedures applicable to non-performing loans, which is usually standard practice in countries with a legislative deficit. In the practice of Hungarian banks, the decoupling of the loan interest rates from the CHF reference rate – in contrast, for example, to the pricing practice in Poland – further worsened debtors' solvency. Legislation put an end to this in 2012 by adopting the act commonly referred to as the Transparent Pricing Act, and later, in 2015 the possibility of changing the interest rate spread and the interest rate was regulated. The unfair practices of banks, and the resulting losses of the customers, were stopped by the related Curia's unity of laws resolution and later by the Settlement Act. Referring to the Habitat for Humanity report, it is established that the problem of crisis legacy has not been resolved, and today it is primarily of social nature. The author also makes a few critical remarks in relation to the early repayment at preferential exchange rate and NET, and at the same time makes a recommendation for the development of an income-proportionate collection system tailored to non-payer debtors. In relation to the present credit cycle, the stability risk may be represented by the interest rates, where – as a result of the MNB's regulatory measures – interest rate fixation gained ground in new lending.

In the work *"Legal measures in Hungary aimed at the management of the problems related to foreign currency-denominated consumer loans", Balázs Bodzási,* the editor of the book, highlights the dominant role of property ownership in Hungary and recalls that home creation has always played an important role in economic and social policy. Foreign currency loans, which featured particularly favourable initial instalments and an initially stable exchange rate (but completely disregarded the risks), "substituted" the cancelled interest subsidy. In this period, banks tended to make their decisions based on the collateral. Accordingly, households were "creditworthy" for having their own home even with a lower wage level; in 2004 this resulted in the construction of 43,000 new homes. Following the appearance of pass-through from the crisis and the painful effects thereof, the author deals in detail with the civil law features of the foreign currency-denominated loan contracts. In relation to the nullity of the contractual schemes, he recalls the position of the Curia, according to which the scheme does not breach the law, is not against good morals, is not usury, is not aimed at impossible services and is not a fictitious contract. However, after signing the contract changes occurred in the lending relationship which generated severe disproportions. Although this does not make

the contracts void, subsequent intervention may become necessary if the parties fail to remedy it jointly. And this is already the case of contract amendment by law. As regards the issue of unfairness, the validity of the scheme does not preclude individual nullity; in this regard, the case of unfair contractual terms and conditions, which has EU legal background, is one of the key issues, the interpretation of which is the competence of the European Court of Justice (ECJ). As regards the requirement of transparency, it was found that it is not the primary subject of the contract that constitutes unfairness, if the terms and conditions are clear and understandable. Within the ECJ's practice, the author highlights that consumers must always receive sufficient information on the legal and economic aspects of the liabilities; furthermore, unfairness may be assessed if sufficient information was not available to the consumer. At the same time, as an open issue, it must be clarified more precisely in which case the lack of information may be regarded as not sufficiently clear and understandable conditions of the contract. In his opinion, open issues include what can be expected from consumers in relation to exchange rate risk, when it is possible to transfer the exchange rate risk fully to the consumer, whether upon full nullity of the contract it is possible to restore the situation before the contract and the type of settlement to be applied between the parties. Finally, he makes a recommendation concerning debtors which did not benefit from the above measures, e.g. for a substantially simplified personal insolvency procedure.

In the volume of essays, *Barbara Dömötör* takes a new approach in her work entitled *"The Hungarian* '*Big short*' *– Rational and irrational reasons for the spread of foreign currency loans*". In this piece, she examines the non-fulfilment of the uncovered interest parity – the financial "story", which was instrumental in the spread of foreign currency lending – i.e. the apparent arbitrage possibility of the inconsistency of the substantial interest spread and stable exchange rate. When foreign currency lending surged, everybody "bet on" the strong forint, and foreign exchange market volatility was dominated by expectations rather than the macroeconomic fundamentals. Technically, a foreign currency loan can be regarded as a forint loan with forward sales of foreign currency, and thus the borrowers were better off with foreign currency loans than with forint loans as long as the (rising) exchange rate remained below the forward rate. Hence, foreign currency lending was nothing more than a "short sale" of foreign currency at a national level. Looking back to 2008, the spot and forward rates suggest that on the whole borrowers of foreign currency loans were better off. In relation to foreign currency loans, the author presents two behavioural effects: framing, i.e. the decision-making environment, which was influenced both by the initial level of exchange rates and the APR calculation method, and the change in risk attitude, were the spread of foreign currency loans supported underweighting of the related risks. She establishes that for the individual decision-maker a foreign currency loan represented a better alternative than a forint loan even under a higher level of risk aversion, and thus it was possible to justify the decisions rationally. On the other

hand, the perception of losses was heightened by the fact that level thereof was not compared to those on forint loans. Based on this, although a foreign currency loan may be a realistic option in the corporate sector, for households it represents a nationwide burden, and thus regulatory restrictions must be in place to prevent the generation of systemic risks by rational decisions at the level of individuals.

One of the most comprehensive analyses of the publication, presenting the cause and effect circumstances, is the work by *Bálint Dancsik, Gergely Fábián and Zita Fellner (Circumstances of the development of foreign currency lending).* The historical review recalls the most important cornerstones related to indebtedness. The first credit cycle since the turn of the millennium was supported both by demand and supply factors: the state interest subsidy, then the interest spread of foreign currency loans under stable exchange rate, which was strengthened by the shift in banking competition to the retail market. At the same time, by 2008 the shortcomings of the consumer protection regulation, monetary policy struggling with high inflation and financial imbalances left Hungary in a vulnerable situation. By then, the majority of outstanding borrowing of households was already dominated by foreign currency loans, with nobody clearly bearing the responsibility for this; moreover, there are even arguments why it may have appeared to be a rational decision; in addition, the pre-crisis narratives also supported the developments. The consequences are known. The purpose of the paper is to synthesize the reasons from two aspects: presenting the reasons in a context and analysing the lasting consequences of the "original sin". The spread of foreign currency lending was conditional on the "willingness" of three actors, namely: the preferences of households, banks' access to foreign currency funding and permissive regulations, i.e. on the whole, demand, supply and institutional conditions. Of these, within households' motivations it is easier to make a distinction between demand and supply effects by questionnaire-based surveys. The micro-level surveys highlight households' expectations, trust, wealth position, financial awareness and risk assumption. When examining the motivations of the supply side, it is clear that as a result of the saturation of corporate lending, financing was diverted to the retail market, which – bearing in mind the state subsidies – appeared to be good timing: the range of creditworthy and solvent debtors increased. When the interest subsidy was cancelled, only foreign currency loans were able to guarantee the price level necessary to maintain solvent demand and the profit, which exceeded that realisable on corporations. With saturation of this market, banks clearly moved toward risk-based competition. The necessary foreign currency funding was provided in two ways: short-term external, typically parent bank, funds and through off-balance sheet foreign currency swaps. At the same time, the rise in the loan-to-deposit ratio also indicated that the sector became increasingly dependent on short-term external funds and the rollover of such. The most important institutional conflicts included (1) the central bank's policy, which, according to some, excessively overcompensated inflation and sovereign risk, which led to

a stronger than “adequate” exchange rate; (2) consumer protection regulation, where the rules imposed no particular restriction on the process, and it was not clear which institution should deal with the macroprudential problem, and the instruments allocated were also unsuitable; and (3) the conditions of alternative financing and access to bank funding. After the crisis studies focused on identifying the development process. They pinpointed the trends that led to increasing vulnerability and the odds of a bank crisis. Common features included the outflow of credits in large volumes, deterioration in the balance of payments, reliance on short-term external funding and a major positive credit gap. In 2005, outstanding lending in Hungary exceeded the equilibrium level, reaching its maximum in 2008–2009. The balance of payments deficit was mostly financed via banks’ short-term external debt, and thus two “conditions were met”. However, it should be noted that credit outflow did not heat the real estate market to the same degree as before or similar to other crises. At the individual level, the realisation of the exchange rate risk and the interest rate increases by banks had a considerable effect, as a result of which the instalment on a typical mortgage loan rose by 80 per cent. It can be also clearly identified that a large part of the non-performing loans – 60 per cent of the present portfolio – can be linked to a narrow period of risk-based competition.

The purpose of the second work by the MNB’s experts, *Bálint Dancsik, Gergely Fábián and Zita Fellner*, entitled *“Beyond finances: Why don’t delinquent households pay?”* is to identify the factors that influence the debt servicing capacity and willingness of non-performing debtors or those with restructured loans. The paper examines the changes in the amount of these debtors’ outstanding debt in 2014–2015, considering the income position of the debtors, the loan characteristics and the features of the settlements. The analysis found that there was less chance for a decrease in the debt for those with higher relative indebtedness, i.e. where the loan-to-value ratio (LTV) is higher due to the lower income or higher number of dependents. The research identified the factors that reduce willingness to pay; namely, when the outstanding debt rose several times compared to the loan amount drawn down, when the purpose of the loan was consumption, or when there are several non-performing debtors at the given place of residence. They also examined the effect of social capital and “social stigma”, as well as the length of the default. It also bears significance to which institution the debtor owns money, which may indicate to what extent collection strategies motivate debtors to perform. At the same time, it reduced the debt when the institution terminated the loan contract, the loan was restructured, the debtor had higher income or real estate prices rose in the respective settlement.

In his work *“Some experiences of the defendants in litigation related to foreign currency loans”*, *Zsolt Lajer*, with his vast experience in foreign currency loan litigation from the aspect of banks, recalls that the disputes – the number of which increased tangibly from 2011 – are still ongoing at all levels of the judicial system. The history of these cases is not too long, but it is by no means closed. Thus, at

present the author may share only temporary, partial and subjective experiences. At the same time, the repayment difficulties that led to the legal disputes can be linked not only to the "foreign currency lending", but also to the high degree of indebtedness and the deteriorating repayment capacity after the outbreak of the crisis. The author finds that there is no major difference in the NPL ratios at the product level (foreign currency/forint), although the matter was taken to court almost only by foreign currency borrowers. However, a larger part of the issues discussed in the cases could as well relate to forint lending. It was a shocking discovery in the litigation that in such a well-known legal area as foreign currency lending, the general terms and conditions or nullity of the contract raise basic questions with no answer from modern legal practice, and these were also not addressed properly upon drafting the contracts. The author demonstrates several examples of the consequences of imprudent action triggered by "coercion to act", related to EU law, examples abroad or the self-regulation of market participants. As regards the banks, he found that during the litigation they failed to manage properly the often justified criticism and professional issues. The banks' attitude to the right of unilateral contract modification or clearly explaining the absurdity of some of the plaintiffs' train of thoughts deserve attention. The author is of the opinion that by now the cases are also driven by the (business) interests of the legal representatives involved. The partial wins in the cases are often only judgements of marketing value. At present, it is uncertain when the legal disputes may end, and when new ones may commence. However, the resolution of the problem is conditional on the following factors: the financial and housing situation of the debtors should be settled, which requires support from the state, such as the tenement flat programme or the recast of personal insolvency. It should not be worth it for the "industries" overlaying the debtors to convince the stakeholders to start new litigation. This requires firmness in judicial practice and action from the chambers. Based on the example of the exchange rate spread and the unilateral contract amendment, the author urges the legislator not to wait for years before taking corrective actions in similar cases.

As regards the regulatory issues, *Izabella Tebeli ("Importance of financial consumer protection in the stress situation generated by foreign currency loans")* recalls that the intensive enhancement of consumer protection commenced only after the crisis both in Hungary and in the EU. This was also triggered by a kind of pressure. The authors allocates government measures to three groups: (1) direct assistance for debtors in a difficult situation, which became increasingly direct from the first agreement with banks in 2008 until the legal measures after 2011; (2) taking consumer protection measures to ensure proper information on the risks inherent in borrowing and the features of the product; (3) measures aimed at enhancing the financial awareness of the population, the purpose of which is to make households capable of assessing risks and making conscious decisions. The paper examines the government's measures in the period 2009–2017, as to what degree those assisted

debtors. The author finds that after 2008 the state replaced the former neoliberal policy – relying on the self-regulation of the market – by clearly taking a regulatory position. The measures taken followed the "middle course", by sharing risks among the participants, where the primary goal was to guarantee housing and then to eliminate the exchange rate risk. Presumably, the individual measures alone would have not been sufficient; however, the solutions built on each other and offered to different clients provided significant help. The spread and deepening of financial literacy, with the collaboration of the market participants at all levels of society, is a necessity across cycles.

In addition to retail foreign currency lending, which attracted great attention, in his paper entitled *"Developments and risks of corporate and project financing foreign currency loans in Hungary", György Walter* touches on the corporate lending practices, and particularly on project financing. The available data and literature already allow for an analysis of the segment, which was characterised by similar risk-based "excessive lending" as the retail sector. The main issues presented in the paper are: How did the dynamics of foreign currency lending and risk figures change before and during the crisis compared to forint loans? How was this influenced by project financing? From the 2000s, foreign currency loans were key to the surge in outstanding lending and also to the reduction thereof. He finds that within corporate loans, project financing was dominated by foreign currency loans, accounting for roughly 90 per cent of the loans. After the crisis, these decreased more slowly due to the inflexibility of the project structures, the longer maturities and slower realisation of collateral, as well as to the cautiousness of banks. When examining the risk indicators he found that banks had to recognise higher provisions for foreign currency project loans and the portfolio was characterised by much worse NPL ratios. According to the author, later on it would be also worth examining why the higher provisions for foreign currency project loans were recognised only with a delay. Experiences show that the workout process of these loans dragged on, and thus they remained in the balance sheets much longer, exerting a prolonged negative effect.

In her paper entitled *"Foreign currency-denominated lending as seen by the regulator", Aliz Zsolnai* points out that in a process similar to the spread of foreign currency lending it is the responsibility of the regulator to act proactively, and if that proves to be insufficient, to intervene reactively. Consumer protection is key to counterbalancing the information and knowledge asymmetry. In terms of the success of the regulatory measures the receptiveness of the actors was determinant, which was also corroborated by the continuously increasing level of the debt burden. On the other hand, the firmness of the regulatory measures also increased in parallel with the escalation of the problem from the level of individuals to the vulnerability of the economy, while the way for the closing steps – which ended the vulnerability of the debtors, the financial sector and the state, resulting from the foreign currency-denominated loans – was cleared by the decision of the Curia.