
Regulation of Foreign Currency Mortgage Loans

- the case of transition countries
in Central and Eastern Europe

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Questions to be answered

- What is the scope, features and drivers of FX mortgage lending?
- What happened to FX mortgage portfolios in 2008 turbulence ?
- How (and why) did regulators respond and how effective were their responses?
- Some recommendations

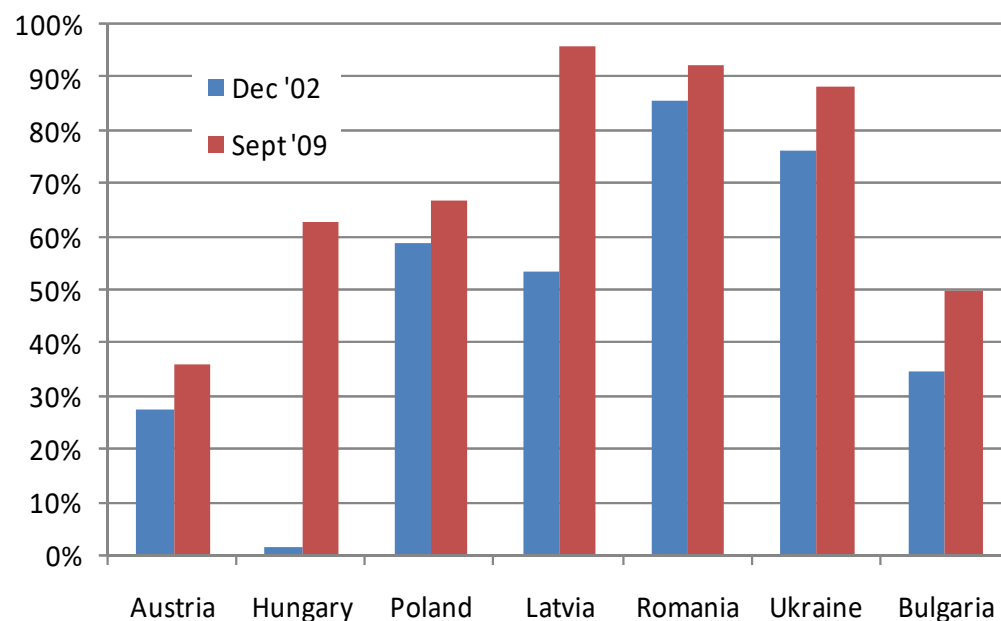
Study covers

- Poland as Hungary – both users of Swiss Franc lending
- Latvia – using currency peg
- Ukraine – classic dollarization case
- Austria as Eurozone comparator, source of cross-border lending

Scope and features of FX mortgage lending

- Most transition countries started with some FX lending. Only few did without (Czech rep).
- Loan amount indexed to foreign currency implying negative amortization risk in local currency:
 - Depreciating exchange rate in the long-term (PPP)
 - However, volatility may occur in the short-term due to capital imports.
- Interest rates indexed to foreign benchmark rates or reviewable by lender, usually short-term.
- Some risk layering (IO & repayment vehicle loans, self-certified, condo flipping), but generally not subprime.

Share of forex lending in the outstanding mortgage portfolio in selected transition countries 2002 and 2009

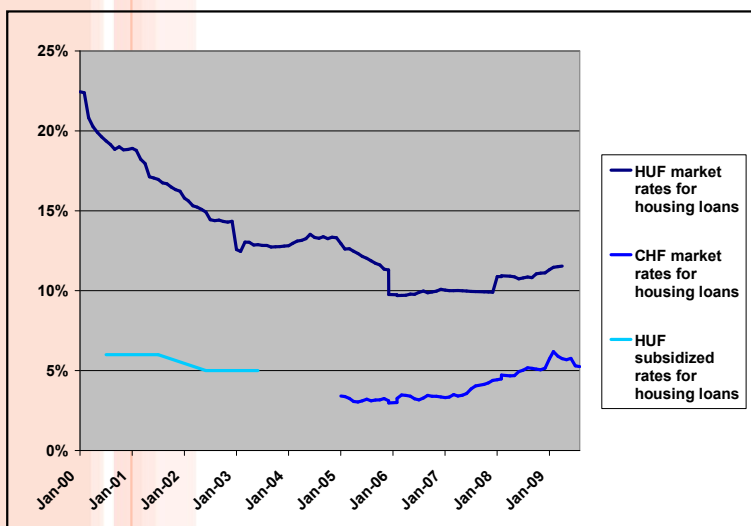


Drivers of FX lending

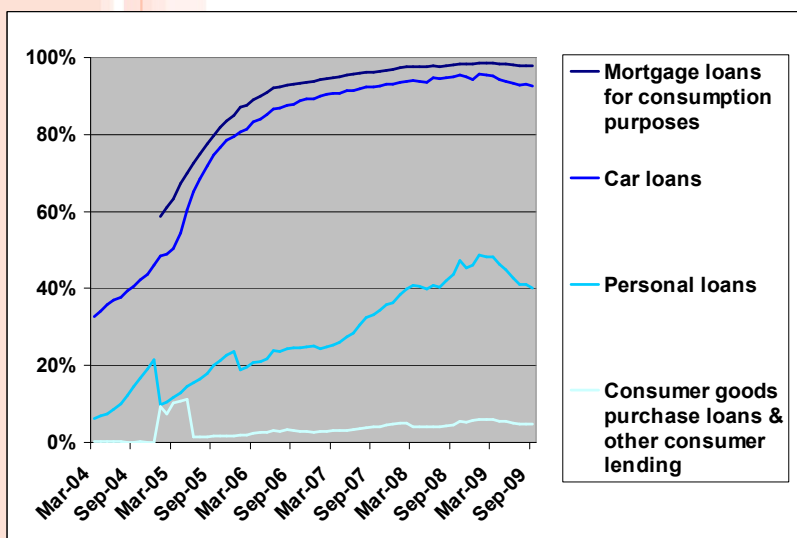
- Interest rate differentials / ‘carry trade’
 - Standard argument (IMF), but in many cases too small to explain scale.
- Nominal interest rate level or ‘Tilt’ effect
 - Absolute affordability limit specific to long-term lending, relevant in high-inflation countries.
- General dollarization
 - Of the economy (borrower incomes) or property market.
- Failure to establish local currency funding base
 - Due to excessive subsidies and insufficient macro stabilization.
- Cross-border capital flows
 - Funding source bias, exacerbated by home country matching regulations.
- Foreign Currency as an entry/competition tool
 - Aggressive foreign entrants using non-risk adjusted pricing.

Demand drivers – case study Hungary

Market and subsidized HUF rates, market CHF rates



Market share of FC in mortgage and consumer lending

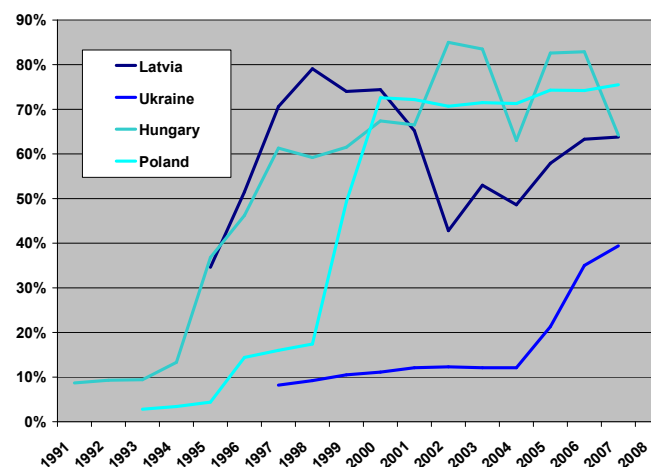


- Large interest rate differential (inflation).
- Interest rate subsidies for local currency lending were too high, program cancelled.
 - Czech rep successful, at lower interest rate subsidy levels.
- CHF lending continued low interest rate market (JPY market was narrowly avoided).
- ‘Tilt’ effect leads to far greater FX market shares in mid- and long-term lending compared to short-term lending.

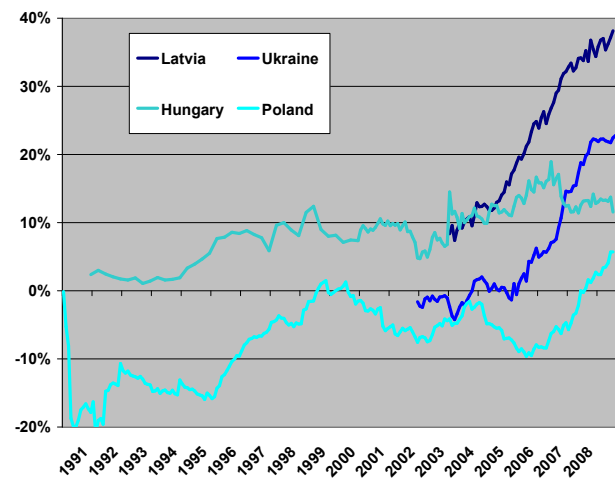
Supply drivers – funding market and entry

- Entering foreign banks with limited access to deposits, unless if buying the main retail banks.
- Some countries with limited deposit base (e.g. Latvia depleted by 1999). Result are high capital imports to finance growth.
- Aggressive entry strategies: domestic lenders have problems to compete with FX product.
 - Hungarian banks needed up to three instruments to fund CHF loans (CHF/EUR swap, EUR bond or HUF deposits and EUR/HUF swap).
 - Foreign banks use riskier products abroad than at home (e.g. no caps).

Share of foreign bank ownership

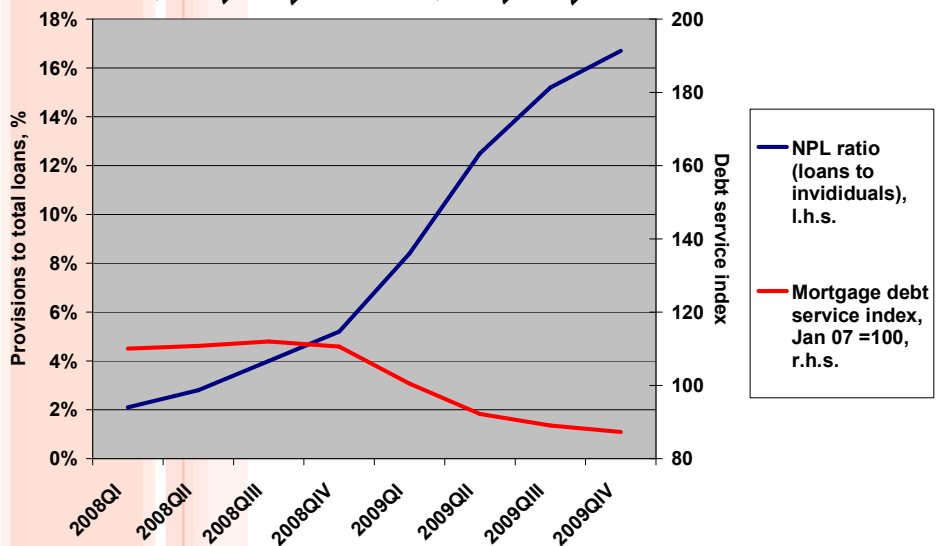
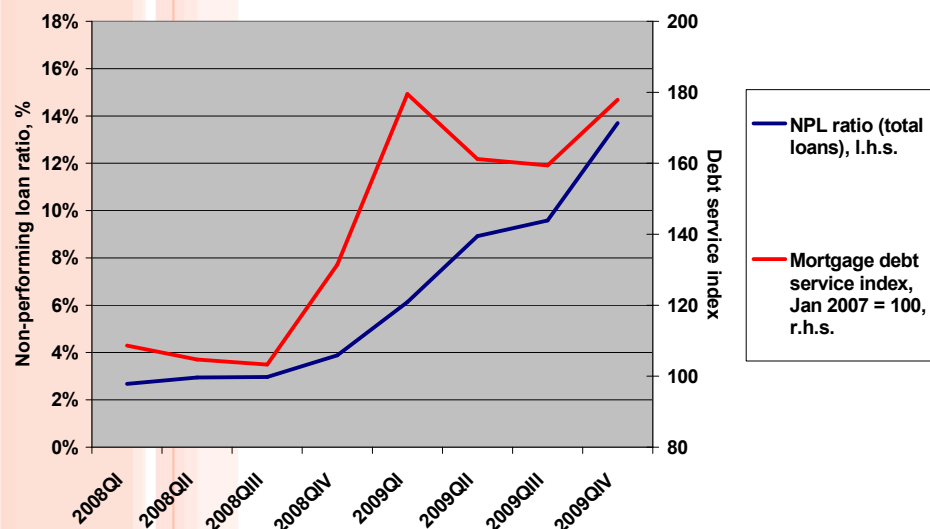


Net foreign debt position of the banking system

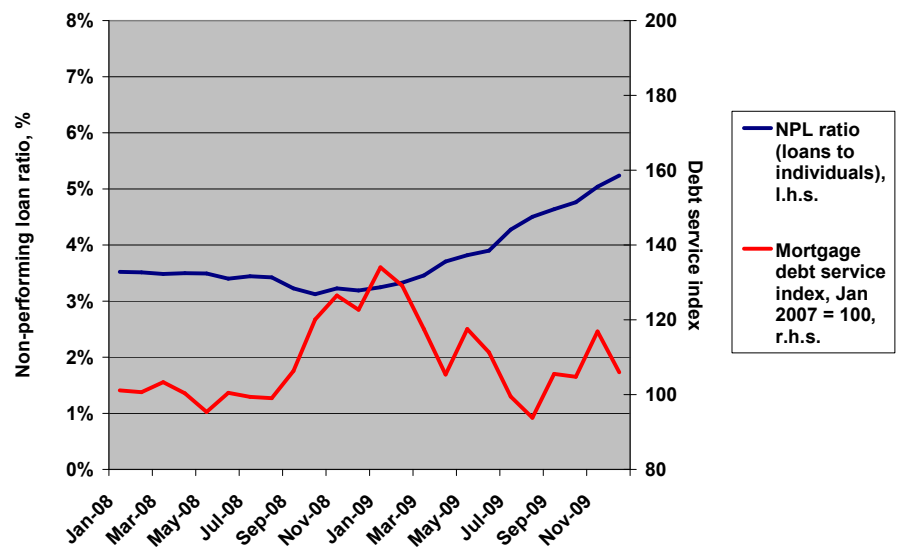
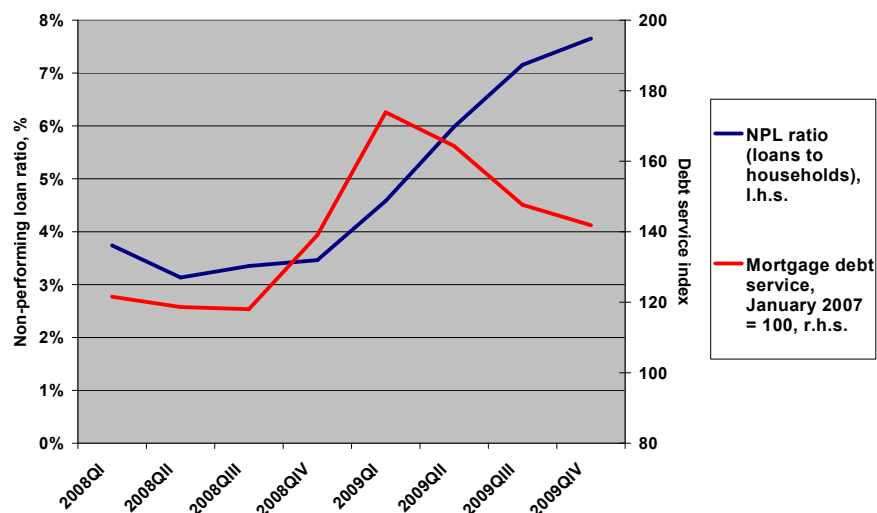


Risk realizations: NPL and mortgage payment shock

USD/EUR markets – Ukraine / Latvia

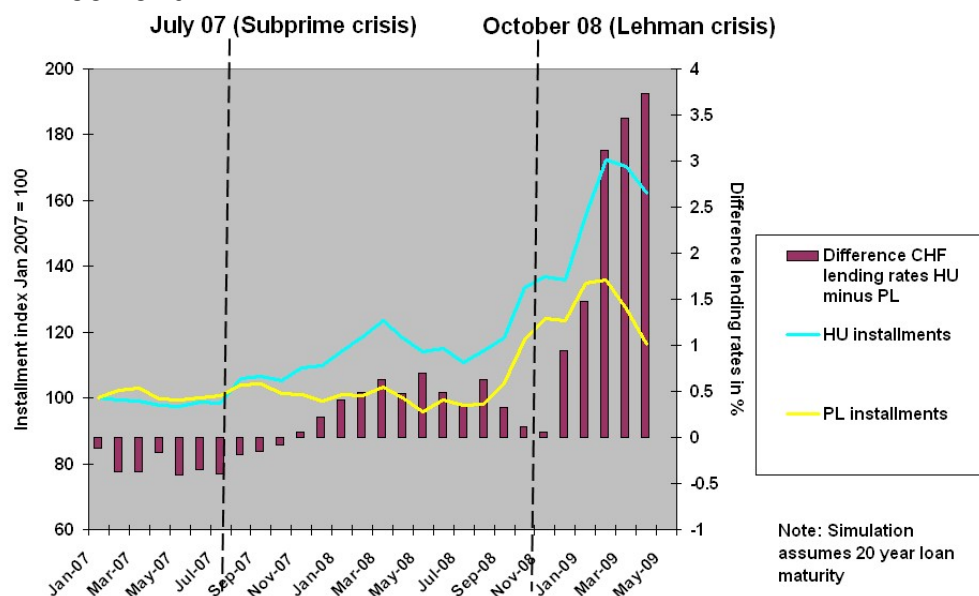


CHF markets – Hungary / Poland

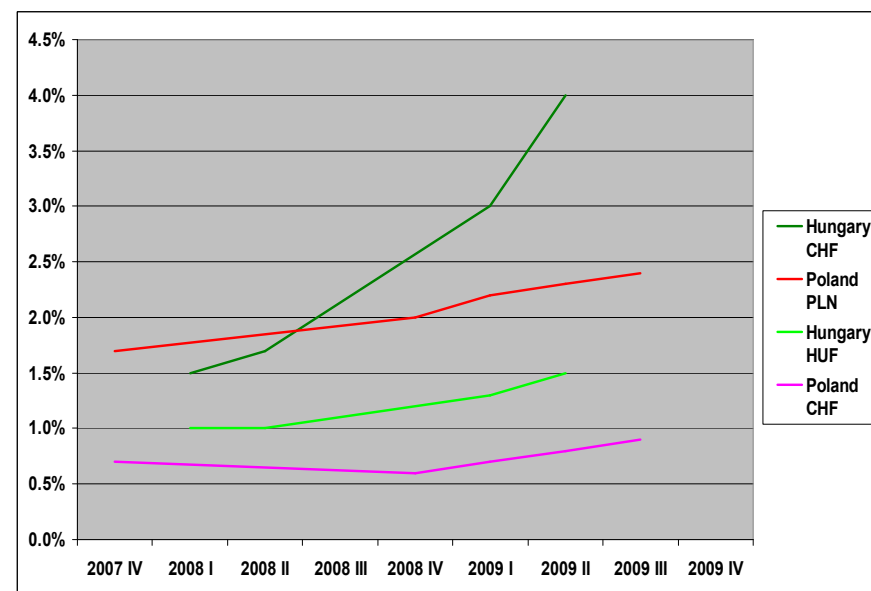


Hungary vs. Poland payment shock and relative delinquency rate detail

Interest rate and installment differentials 2007 cohort



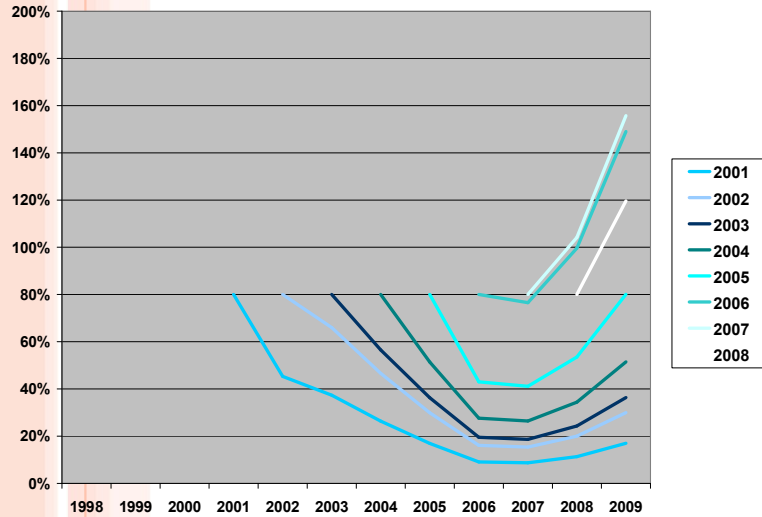
CHF vs. local currency delinquency rates



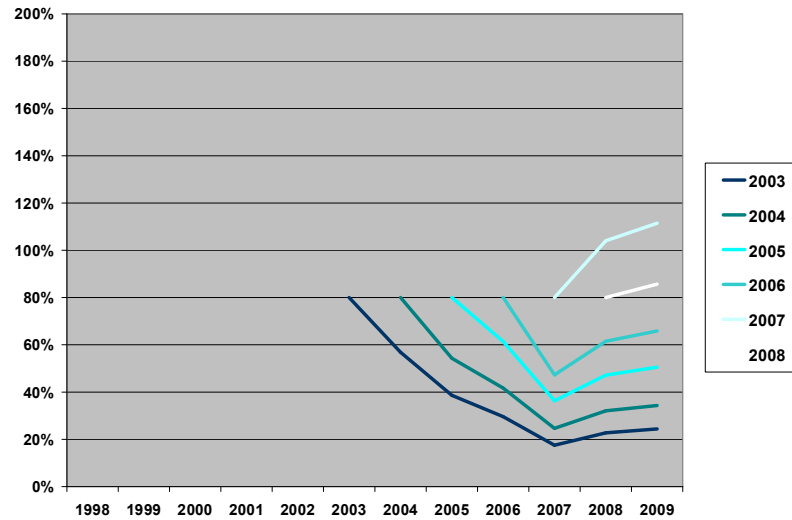
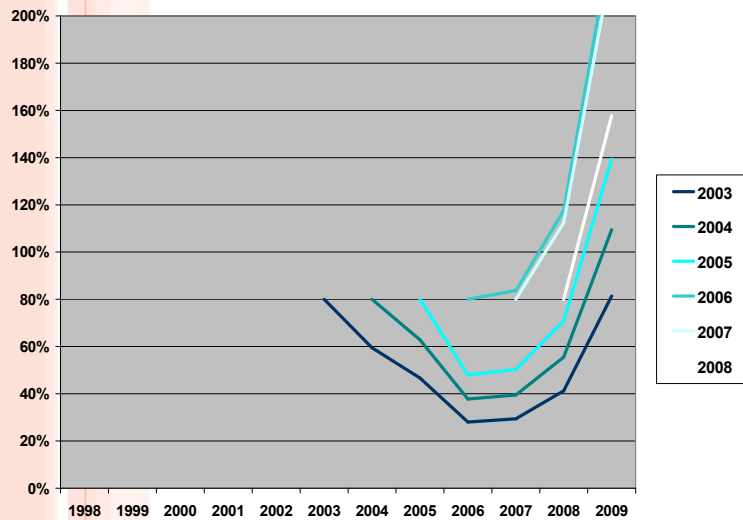
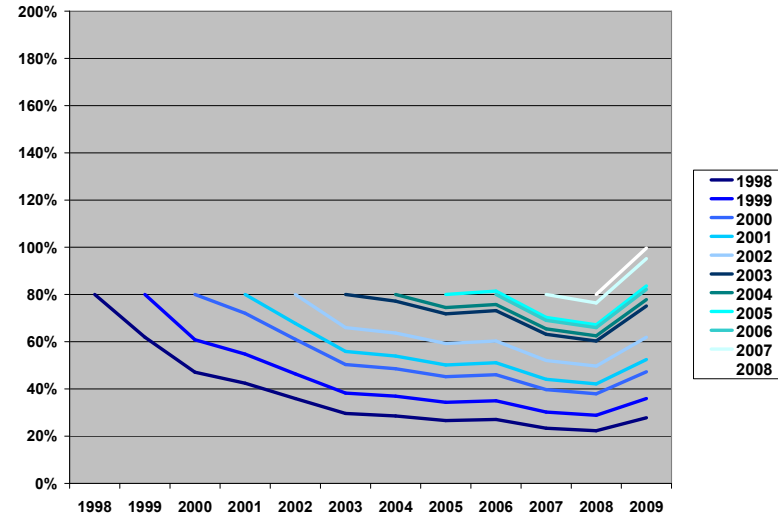
- Polish banks mostly tie CHF rates to a CHF money market index; this creates what one could dub ‘policy hedging’, i.e. a bet on Swiss central bank action.
- Hungarian banks practice “reviewable” CHF rates, i.e. pass through funding cost changes; result is lower cost of funds risk bought by higher default risk.

Negative equity shock in house price bubble markets

Ukraine / Latvia



Hungary / Poland



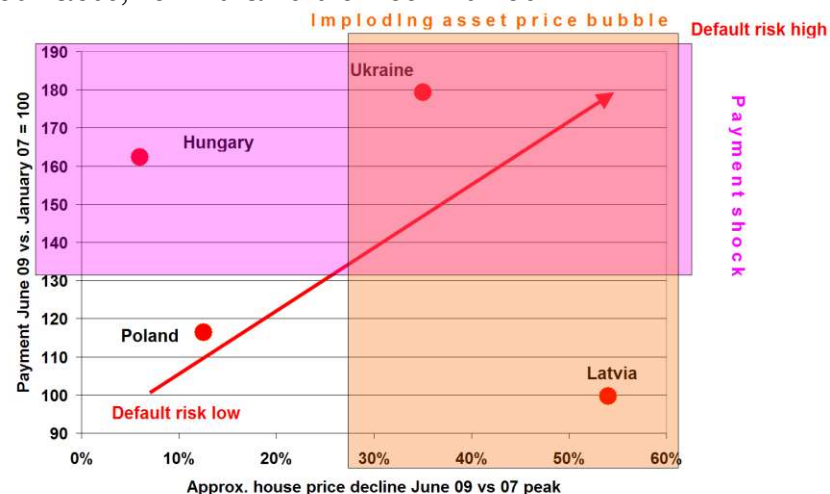
Danger zones – FX is only one factor

- Cumulation of FX and interest rate shock generates cash flow risk.
- Cumulation of cross-border flows, tight urban markets (Riga, Kiev) and FX generates negative equity risk.
- Follow-on effects (unemployment, economic crisis)

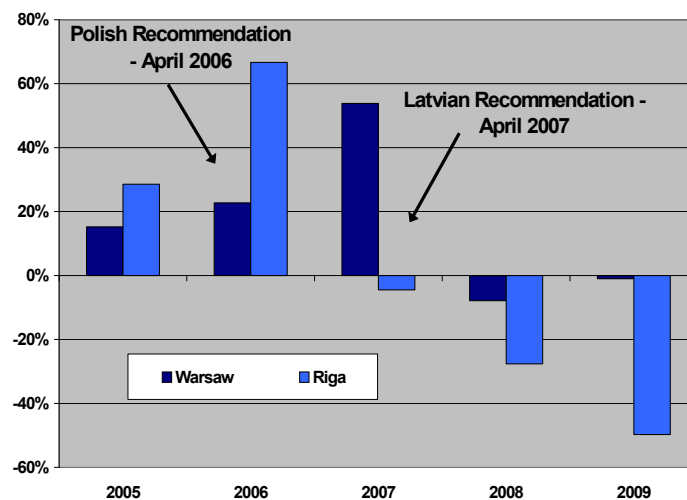
Risk mitigants (historical):

- Contractual features (Poland, Hungary and Ukraine failure)
- Early deflation attempts (Poland)
- Risk transparency (Hungary, Austria ag. JPY loans)
- Stress testing (Poland)
- Conversion options (all ex Poland)
- Land and housing supply policies (Latvia, Ukraine failures)

Stylized facts, four transition countries



Apartment price inflation in Warsaw and Riga, regulatory intervention



Evaluation of regulators' responses

- **Hungary** – Limited response to FX lending boom following discontinuation of Forint subsidies (JPY). Recently very tight under-writing requirements (LTV) and capital requirements making FX loans uneconomic and unaffordable. Extreme bias now against CHF (in favor of EUR).
- **Poland** – One of first to react with strong rules on under-writing (debt service stress) but temporarily not enforced.
- **Latvia** – No response to FX lending, although some anti-bubble measures. Euro loans now encouraged as part of debt restructuring package and FX share still rising.
- **Ukraine** – Very late response post devaluation, and outcome was a unilateral ban on FX loans. Lacks credibility as local currency rates ballooned.
- **Austria** – Some good steps on consumer information, but slow to spot and react to carry trade problem with borrowers using investment vehicles to repay loans.

Conclusions

- FX lending not can fill a gap caused by no affordable domestic alternative or constrained access to domestic long term funds, but...
- ...need to consider appropriate conditions:
 - Liquid currency (swap market, access to liquidity lines, long term funds)
 - Stable exchange rate – no ‘exotics’
 - Interest rate indexing (Polish indexed rates) - avoid pass-through of costs of funds
 - FX caps (all cases ex Poland already require banks to offer conversions)
 - Stress testing and LTV limits – but in line with actual risk profile
 - Not used for speculative purposes – ‘carry trade’ motive
 - Avoid risk layering

Recommendations

- **Clarification of the role of foreign currency mortgages**
 - Ban where feasible (low-inflation context) or limit to FX earners
 - Where need to keep product: clarify purpose, regulation, shock protections.
- **Developing the domestic currency alternative**
 - Targeted use of subsidy mechanisms when declining inflation
 - Consider 'inflation proof' loans, where inflation hard to combat
- **Optimizing FX lending bank regulation**
 - Underwriting rules, capital rules, liquidity management for lenders
 - Greater cross-border cooperation between central banks
- **Optimizing FX lending consumer protection**
 - More than just 'tick-box' disclosure
 - Stress-testing, LTV limits and scenarios to restrict underwriting
 - Lender protection of consumers - eg caps on negative amortization, conversion option - may render underwriting limits more flexible