LENDING IN FOREIGN CURRENCY AND CURRENT CHALLENGES AT EUROPEAN LEVEL

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In recent years, most countries in Central and Eastern Europe, Member States of the EU, that we selected for the analysis (Bulgaria, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania) have recorded a significant expansion of lending in foreign currency, which was one of the major factors of the accelerated growth of loans to economy. Such developments have led to an increase of indebtedness in foreign currency of the non-financial private sector, especially of the households and of the accumulation of major macroeconomics and financial imbalances.

The extremely negative implications of lending in foreign currency on financial stability in most countries under review, outlined clearly in the context of the current crisis, determined the focus of the policymakers concern, both at European and national level, regarding the issue of foreign currency loans, which became one of the most discussed issues on the agenda of the monetary-financial authorities.

The aim of our research is to comparatively underline, based on the example of the panel countries, a few stylized facts about lending in foreign currency, and also the main factors which determined the growing share of loans in foreign currency, the risks for financial stability generated by the loans denominated in foreign currencies and the challenges that arise for the monetary-financial authorities, both at national and European level, in the current context and in the post crisis period.

The methodology used in our paper starts with an extensive literature review in order to underline the importance of the research theme approached. The analysis is based on information and statistical data provided mainly by the official statistics of the ECB, IMF, EBRD, Raiffeisen Research, different reports, studies and researches.

Through the content of our research we want to underline the crucial importance of a rigorous monitoring of the foreign lending activities undertaken by the central banks and the supervisory authorities in order to limit the risks and to ensure the financial stability at EU level.

Key words: foreign currency loans, New EU member states, risks, tools, financial stability
JEL code classification: G21, E44, E51

1. Introduction

In the pre-crisis period, most countries from Central and Eastern Europe, Member States of the EU (Bulgaria, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania), taken in the analysis, experienced a rapid expansion of lending in foreign currency, which was assessed (Unicredit 2011: 19), as one of the engines of the powerful economic growth because without domestic long-term financing sources of local banks and high domestic interest rates, the use of international funding in foreign currency by the domestic banks have supported local economic growth. On the other hand, foreign currency lending has become a source of instability by feeding the unsustainable economic growth and also the consumption boom.

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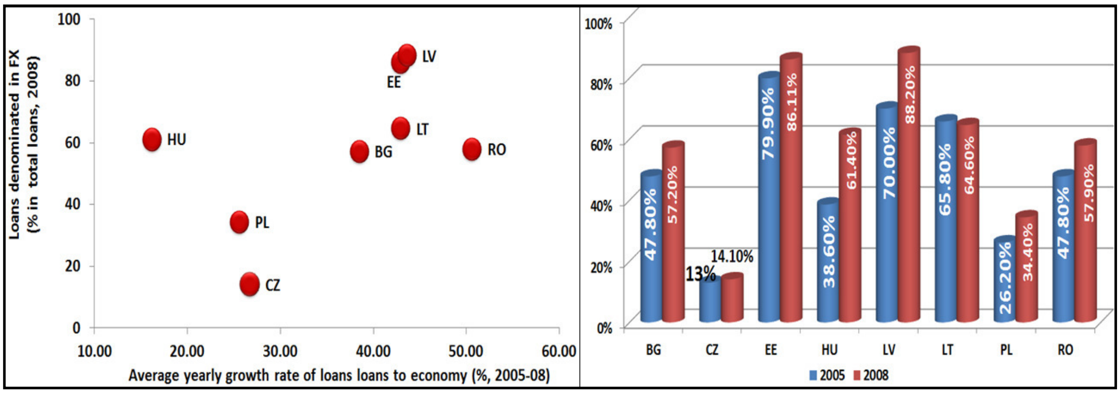
currency loans, which became one of the most discussed issues on the agenda of the monetary-financial authorities.
The aim of our research is to comparatively underline, based on the example of the panel countries, a few stylized facts about lending in foreign currency, the main determinants of the growing share of loans in foreign currency, the risks for financial stability generated by the loans denominated in foreign currencies and the challenges that arise for the monetary-financial authorities, both at national and European level, in the current context and in the post crisis period.
The rest of the paper is organized as follows: *the second part* is dedicated to a literature review; *the third part* reflects a few stylized facts about lending in foreign currency and the main determinants of growing share of loans in foreign currency; *the fourth part* discuss the main risks generated by the expansion of lending in foreign currency and current challenges faced by the policymakers, at national and European level. Our study ends with concluding remarks.

2. Literature review
Lending in foreign currency, the determinants and the risks which they present to financial stability were the subject of numerous studies. Thus, Basso, Calvo-Gonzales and Jurgilas (2007) have argued in the performed analysis, on the example of the 24 countries with economies in transition, that the main determinants of lending in foreign currency was the dollarization of loans to the private sector, the presence of foreign banks that had an easy access to external financing and the interest rate differential between local and foreign currency instruments. In a similar way, Rosenberg and Tirpak (2008) using panel regression analysis for the period 1999-2007 show, on the example of new member states from the European Union and Croatia, that between the main factors that caused a significant increase in foreign currency loans was the interest rate differential between loans in domestic and foreign currency and the extent to which lending is based on funding from abroad rather than domestic deposits.
In the study realized by Csajbók-Andras et al. (2010) in which they analyze household foreign currency borrowing in 10 new EU Member States, the authors confirm among the determinants of lending in foreign currency, the importance of the interest rate differential and exchange rate volatility, and also add as a determinant of the foreign currency loans, the institutional features of bank lending, such as the prevalence of variable versus fixed rate loans.
The study realized by Zettelmeyer, Nagy and Jeffrey (2010) on the example of emerging Europe highlights as the main determinants of lending in foreign currency, which are also the best predictors on the share of lending in foreign currency, inflation volatility, the differential between local currency and foreign currency interest rates and foreign financing of domestic banks.
Another significant issue addressed in the literature in this area regarding foreign currency loans refers to the role of the monetary policy in limiting growth of these types of loans. Thus, besides the mentioned authors there are other authors such as Sirtaine and Skamnelos Sirtaine (2007), Hilbers et al. (2006), Brzoza-Brzezina et al. (2010) which showed that foreign currency loans can be problematic for central banks, in terms of a restrictive monetary policy in order to limit excessive credit growth which may lead to increased foreign currency denominated loans.
Our paper complements the specialized literature on the approached subject, in particular, by highlighting and discussing current issues of high interest for policymakers, both at national and European level regarding lending in foreign currency.

3. The dynamic of lending in foreign currency and its determinants
Extremely rapid growth, expressed through two digits, of loans to economy and the majority share of loans in foreign currency was a significant common feature of financial intermediation for all countries analyzed in the study, except the Czech Republic and Poland. In agreement with the literature (ECB 2010a: 162) it seems that there is a strong link between rapid growth of loans

and lending in foreign currency. The data in Fig. no. 1 shows that the countries where there were recorded the highest rates of growth of loans to the economy (i.e. especially Romania, the Baltic countries and Bulgaria, where the average yearly growth rate was about 51%, over 42% and respectively over 38%) are those where foreign currency lending has a majority position. Therefore, we can say that foreign currency lending was a significant determinant of bank lending accelerated growth in most analyzed countries.

Regarding foreign currency lending as a share of total lending (see Fig. no. 1), we remark with reference to 2008, that the countries considered in the study are distributed between two extremes, as follows: at the upper extremity are Latvia and Estonia, where the share of loans in foreign currency was of 88% and 86%, and at the lower end is Czech Republic with a share of loans in foreign currency only of 14%. Between these two extremes lie Lithuania, Hungary, Romania and Bulgaria where the share was above 50%, while in Poland the share was 34.4%.

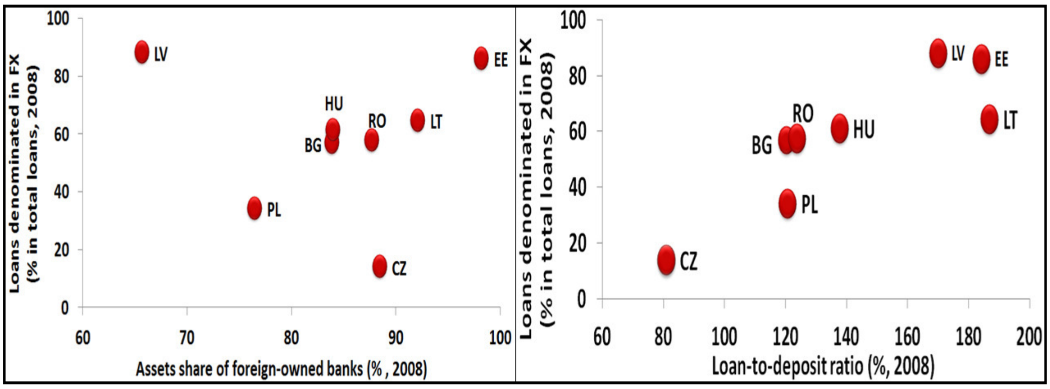


Source: Own calculations based on data provided by ECB, 2008, 2010b, IMF, Country Reports, Raiffeisen Research, 2010

Fig. no. 1: The relationship between loan growth and foreign currency lending (as a share of total lending)

The dominant position of foreign currency lending in most of the analyzed countries is the result of the action of several factors related to both supply and demand (ECB 2010a: 162; National Bank of Poland 2010: 42). Among this factors stands out in particular: on the supply side, financial market liberalization and the increase share of foreign capital on domestic banking markets, which have contributed to increased competition in banking markets and reduced domestic saving which stimulated the increased funding from international markets; in terms of demand of loans, a significant contribution to the expansion of foreign currency lending had the spreads between the interest rates for foreign currency-denominated loans and the interest rates for domestic currency-denominated loans, and also the exchange rate policy, which especially in countries with particularly currency board arrangements has encouraged borrowers to contract foreign currency-denominated loans because the foreign exchange risk was perceived to be small compared with the countries with flexible exchange rate arrangements.

The significant presence of banks with foreign capital on domestic markets and easy access to international financing, particularly through funding from foreign parent banks had a significant contribution to the expansion of foreign currency lending. Also, easy access of banks to foreign capital determined the more rapid increase of credit expansion compared with the domestic deposits, issue revealed by the loan-to deposit ratio, which in 2008 stood at over 100% in all countries, except the Czech Republic where banks have greater independence from external funding. Based on these claims, but also on the data in Fig. no. 2 we remark the manifestation of certain significant direct link between lending in foreign currency on the one hand, and the asset share of foreign banks, and loan-to deposit ratio, on the other hand.



*measured by the asset share of foreign banks and by loan-to deposit ratio.

Source: EBRD, 2010 and Raiffeisen Research, 2010

Fig. no. 2: The relationship between the expansion of foreign currency lending and the dependence of banking sector on foreign capital*

4. The risks generated by foreign currency lending and current challenges

Compared with domestic currency-denominated loans, foreign currency-denominated loans involve a significant additional risk for both borrowers and lenders and the whole financial system, respective the volatility of exchange rates. Under the depreciation of national currency there is recorded an increase of the value of credit in national currency, which can have major negative implications on financial stability given that many of the borrowers do not obtain regular income in foreign currency or they are not protected from exposure to foreign exchange risk (as is the case of households and SMEs). The significant depreciation of the domestic currency means an increase of the value of debt in domestic currency, which leads to the deterioration of the ability of unhedged borrowers to repay their debt and implicitly to the deterioration of the portfolio of bank loans. In this context, it may increase the losses from loans of the banks; reduce interest income and higher provisions. Therefore, in addition to credit risk, the banks are exposed also to earnings risk.

Another major risk that can be generated by the expansion of lending in foreign currency is the risk of financing (ESRB 2011), which may increase while the banks are financed significantly from international markets, rather than retail deposits. The significant reliance on foreign funding of local banks and the manifestation of significant vulnerabilities in countries where banks have their parent banks can lead to major risks in host countries.

Foreign currency lending has major negative implications in terms of financial stability, in particular by increasing bank exposure to real estate market trends, while the foreign currency-denominated loans have a risky share in the housing loan portfolio, like the countries taken in the study, except the Czech Republic.

The expansion of lending in foreign currency and the macroeconomic and financial vulnerabilities recorded in most countries under review determined the policymakers and regulatory authorities to take, during the pre-crisis period, a series of measures, which focused in particular on offer so that foreign lending to be less attractive for banks. Such measures have resulted, in particular (Brown and Lane 2011) in higher risk weights, provisioning or reserve requirements depending on banks' FX exposure, cross-border supervisory intervention, and monitoring FX risk. In terms of demand, only some countries (notably Poland) have adopted reduction measures targeted in this regard, such as the obligation for banks to inform borrowers on the risks posed by foreign currency loans and tightening of eligibility criteria for such loans. But, overall, the efficiency of these measures was limited; especially if we consider that in the analyzed countries full capital mobility is a reality.

In the context of the crisis in most analyzed countries has been a deterioration of the economic and financial situation of the private non-financial sector, a depreciation of national currencies and increased exchange rate volatility, lower asset values, particularly of the housing, so that some unhedged borrowers could not honor their foreign currency debts, which led to a rapid deterioration in loan portfolio quality and a high percentage of bad loans, especially in Latvia, Lithuania and Romania, with a significant negative impact on the profitability of banks. On the other hand, it is surprising that in most analyzes countries foreign currency indebtedness of the private non-financial sector and especially of households, remains at a high level, fact that may threaten financial stability. These facts highlight the need to focus the efforts of policymakers to adopt new measures to limit lending in foreign currency, and especially the vital importance of the adoption of uniform measures at European level to limit the risks of foreign currency loan growth and increasing resistance in the EU financial system.

The major negative issues that may arise from lending in foreign currency in the analyzed countries, in terms of financial stability at the EU level, have determined the establishment of The European Bank Coordination – Vienna Initiative, a working group, that focus on lending in foreign currency analysis. The report prepared by the Working Group, entitled "Report by the Public-Private Sector Working Group on Local Currency and Capital Market Development" promotes as key measures to limit lending in foreign currency: the reduction of foreign currency lending to unhedged borrowers, developing local capital markets and stimulation of domestic savings.

Also, in terms of concerns for financial stability in the EU and given the systemic risks that may have the high level for lending in foreign currency, The European systemic Risk Board (ESRB) has published in October 2011 a list of seven recommendations, addressing to the EU member states, the national supervisory authorities and the European Banking Authority, in order to prevent excessive lending in foreign currency of unhedged borrowers, by improving the provision of information to borrowers regarding risks and to improve the solvency of borrowers. Regarding the effects of the recommendations made by The European Systemic Risk Board (ESRB) is still early to be able to make judgments because the Member States should, in general, implement the recommendations by December 2013, and the ESRB will monitor their progress by applying the "Comply or explain” (Fiorante 2011).

Under the present circumstances, we may state that the central banks and supervisory authorities are faced with new challenges related to the high share of foreign currency-denominated loans, given the limited domestic savings level. Thus, the authorities should channel their efforts towards designing and implementing solutions meant to develop national currency markets, to strengthen the cooperation with the authorities in the countries of origin of foreign banks, and also to thoroughly promote awareness raising campaigns among households on the risk of foreign currency over-indebtedness. Also, if we consider the significant deterioration of the quality of bank loans portfolio in some of the countries surveyed (especially in Latvia, Lithuania and Romania), we can say that a major challenge for the banking sector is "the cleaning" of the bank loans portfolio in order to ensure the recovery of lending.

Conclusions

In recent years, the extremely rapid growth, expressed through two digits, of loans granted to economy and the largest share of loans in foreign currency was a significant common feature of the financial intermediation in all the studied countries, except the Czech Republic and Poland. In agreement with the literature our paper reflects, based on statistical data, a strong relationship between loans rapid growth and lending in foreign currency, which entitles us to say that foreign currency lending can be considered as an engine of loans growth in most analyzed countries.

The expansion of foreign currency lending in most countries included in our sample was mainly due to the easy access of the banks to external financing, the spreads between the interest rates for foreign currency-denominated loans and the interest rates for domestic currency-denominated loans and exchange rate policy from some countries, which encourage borrowers to contract foreign currency-denominated loans.

The extremely negative implications of lending in foreign currency in terms of financial stability in most countries under review, outlined clearly in the context of the current crisis, caused the focalization of the interest of policymakers, both at European and national level, to the adoption of new measures, particularly at European level, that will allow the prevention of excessive lending in foreign currency, and therefore limit its risks.

In the current context, we can say that the central banks and the supervisory authorities should target their efforts towards designing and implementing solutions meant to develop national currency markets, to strengthen the cooperation with the authorities in the countries of origin of foreign banks, and also to thoroughly promote awareness raising campaigns among households on the risk of foreign currency over-indebtedness.

Our research has some limitations related to at least the restrictions on statistical data.

In our future research, we aim to develop the issue of foreign currency lending, especially in terms of analytical approach of risks associate to foreign currency loans and the efficiency of the new measures proposed in the current context at European level to limit lending in foreign currency and to ensure financial stability.

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