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ESRB's first policy recommendation: foreign currency lending

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The ESRB takes up the issue of foreign currency loans. It assesses credit and exchange rate risk and issued its first policy recommendation concerning risk management at both borrowers and lenders as well as the monitoring of outstanding credit and foreign currency funding. This represents a major step in that it presents national authorities with specific recommendations and deadlines in areas the ECB has concerns. That said, the ESRB's policy objectives seem to be split between financial stability and consumer protection. The recommendation suggest several issues, including 1) the impact of the concentration of FIs engaged in foreign currency loans, 2) risk assessments of foreign currency funding venues and methods, and 3) the role of exceptional capital charges. They also raise the issue of how macroeconomic-level exchange rate risk should be shared if such lending is necessary.

Introduction

The European Systemic Risk Board (ESRB) announced its first policy recommendation on 11 October. Specifically, the recommendation assesses the risks posed by foreign currency lending and propose measures designed to prevent a financial crisis, with deadlines given for national authorities to implement the recommendation. though the proposal has received relatively little media coverage, it raises important issues for preventing systemic risk.

Overview of recommendation

From an early stage in the current crisis, there were concerns that foreign currency (and particularly Swiss franc) lending in the countries of eastern Europe would lead to wide-ranging defaults as rising exchange rates pushed up their real values. In response, the ECB and SNB supplied Swiss francs to the central banks of Poland and Hungary in the form of currency swaps, and those in turn provided support for local FIs funding with CHF-denominated operations. Given that the ECB has expressed concerns about this issue via the FSR and other venues, few should be surprised at the content of the current recommendation.

The recommendation and the accompanying Annex analyze data on foreign currency lending in Europe and ask national authorities to implement a seven-part policy response. Specifically, they ask individual FIs to (1) ensure that borrowers are aware of foreign exchange risks, (2) ensure that such loans are extended only to creditworthy borrowers, and (3) establish and enhance risk management systems. In the broader financial system, the recommendation call for a systems to monitor (4) foreign currency lending and (5) foreign currency funding. They also call for (6) a replenishment of bank capital as necessary and (7) fair application of regulation in the host country.

Incidentally, the recommendation do not warn against all foreign currency lending: the focus is on home mortgage loans and not on corporate borrowers, which presumably understand the risks and are capable of hedging against them. In other words, the risk scenario envisioned is of an increase in the value of the lending currency (or a decline in the value of the domestic currency) leading to wide-ranging household defaults, thereby creating bad assets throughout the broader financial system and sparking systemic risk.

Overall impressions

The first notable aspect of the recommendation was the fact that many of them address the macroeconomic policy objective of preventing systemic risk with microeconomic tools. Five of the seven policy recommendations involve microeconomic policy responses from national authorities in the area of supervision. Only two of them (Nos. 4 and 5) are macroeconomic in character. And inasmuch as No. 5 involves the monitoring of currency swaps and other markets, the only measure that is truly macroeconomic is No. 4.

Of course, these recommendations are not alone in exhibiting a disparity between macroprudential policy objectives and tools. Such feature is shared by all debate in the advanced economies. Recommendation No. 5, which calls to monitor the value of foreign currency lending both in absolute terms and as a percentage of GDP, incorporates the methodology of Basel III's "counter-cyclical buffer".

The second point worth noting is the double-track nature of the discussion. Given the ESRB's mandate, the recommendation should seek to prevent systemic risk. As such, it would be natural to expect them to focus on maintaining the health of FIs engaged in the business or improving risk awareness among the households concerned. But inasmuch as the recommendation limit itself to foreign currency mortgages, they include perspectives somewhat remote from financial stability, including compliance with transaction rules and the protection of households with an inadequate understanding of foreign exchange risks.

For the purpose of clarifying the goals of the recommendation, it would be preferable to leave policies for investor protection and so on up to national authorities in a separate form. If the ESRB seeks to go beyond narrowly defined financial stability, it should rather expand its perspective to the question of how to isolate the real economy from potential feedback. If foreign currency lending has grown in order to fund macro-level excess investment in emerging economies, the ESRB should also consider measures designed to improve the macroeconomic investment/savings balance and promote savings in these countries from longer-term perspectives.

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Specific issues in recommendations

Next, I discuss a few issues regarding foreign currency lending that were raised in the recommendation.

First is the concentration of foreign currency lending. As Chart 1 in the Annex shows, foreign currency lending accounts for a high percentage of total lending to non-MFIs in a handful of eastern European countries. And as Chart 3 shows, these foreign currencies cannot be funded locally. Chart 6 suggests that foreign banks (from the perspective of local markets) play a major role in foreign currency lending in these countries. The reasonable conclusion is that foreign currency lending in the emerging economies has involved a competition between a small number of large FIs that differ from country to country.

If so, the concentration of foreign currency lending throughout Europe also has significant implications for the prevention of systemic risk. However, this question may not have been addressed. To be sure, BIS statistics showing the credit distributions of FIs in eastern European markets by company nationality suggest it reflects not just simple business considerations but also long-term political and economic relationships between the banks' home countries and the host country. In other words, a significant concentration of foreign currency lending by developed nation FIs in a given emerging economy may reflect a close economic relationship and therefore does not necessarily point to excessive risk. Still, a high concentration of credit can have a direct impact on the balance sheet health of individual FIs and, if the institution is a large one, could trigger systemic risk.

Second is the risk involved in funding foreign currency. It is only natural that foreign currency cannot be funded in the emerging economies. But the "foreign currency" may be the domestic currency in the home country of the creditor bank. Specifically, Chart 2 in the Annex shows that foreign currency lending in Poland and Hungary is denominated mostly in euros or Swiss francs. If the foreign FIs (or banking groups) providing these loans are based in Germany or Switzerland, these currencies are domestic. As such, they can be expected to have a stable funding base, including access to retail deposits. It would therefore be a misreading of the situation to argue that FIs providing foreign currency lending generally suffer from less-than-robust funding.

As the recommendation argue appropriately (No. 5 above), if these FIs are overly reliant on currency swaps and wholesale deposits, the fragility of their funding arrangements should be made an issue. In the current crisis, for example, some major FIs reportedly found it difficult to obtain US dollar funds on the term market and shifted to currency swaps as a source of funding, which impaired market functions by distorting rates.

The difficulty is how to define "overly reliant." Even the recommendation postpone the setting of specific criteria until 2014. While this may have been done in consideration of the timetable for adopting new liquidity ratio rules under Basel III, it is uncertain whether postponing the work will make it any easier. In any event, until some kind of agreement is reached, it would be difficult for either the ESRB or national authorities to do anything beyond "carefully monitoring" the sources and concentration of foreign currency funding.

Third is the issue of capital charges. The recommendation (No. 6) call for national authorities to began with enhanced supervision by encouraging local FIs to ensure appropriate coverage of risk related to foreign currency lending—and in particular to the synergistic effects of credit risk and exchange rate risk. Only if that is insufficient are they to demand that institutions set aside more capital.

Even under an international agreement like Basel III, national authorities have the discretion to regulate local FIs, and it would be easy to envision them taking such measures. Meanwhile, Basel III (or the Basel II) also takes into account risk related to foreign currency lending. Nevertheless, if the ESRB provides substantial discretion over capital charges for foreign currency lending, FIs might worry that the required ratio would rise each time the ESRB came out with new policy recommendation targeting various financial transaction.

To prevent such concerns, it would be important that the ESRB and national authorities administer capital charges based on international agreements such as Basel III and leave the charges outside these frameworks to exceptional cases, thereby ensuring high transparency and predictability.

Implication (1): macro-level exchange rate risk

When the focus is on foreign currency home loans, as in the recommendation, FI compliance issues make it difficult to sanction large-scale residential lending in foreign currencies if there are any questions about households' understanding of foreign exchange risk. And in fact the recommendation propose encouraging more households to take out home loans in the local currency.

Meanwhile, if the emerging economy invests more than it saves and it is deemed favorable to use overseas funds for the sake of economic growth, or if the nation is only able to borrow from overseas lenders in a foreign currency ("original sin"), some entity other than emerging economy households needs to bear the risks. One option would be for FIs in the host country to borrow in a foreign currency and convert that to the local currency. But this is precisely the arrangement that led to the collapse of financial systems during the Asian crisis. Another possibility would be for the host country government to play this role, but this kind of arrangement has also triggered financial crises in the past.

The remaining option is for FIs in the developed nations to supply loans in the currency of the host country and take on the exchange rate risk. Or these institutions could transfer such risk to market participants via currency transactions. FIs and market participants in the major economies are strictly overseen by the authorities, and it can be argued that they have sufficient capital. That said, taking the foreign exchange risk in emerging economies and passing it back to financial systems in the developed nations is a sub-optimal alternative from the perspective of systemic risk prevention, which is the objective of the recommendation.

Implication (2): application of European crisis

Finally, I consider the ability of the recommendation to prevent a situation like the current crisis in Europe. Of the recommendations, calling on creditor banks to help borrowers understand the risks involved in transactions could help prevent the assumption of excess debt. Similarly, encouraging appropriate risk management at creditor banks would help prevent a crisis at major FIs from triggering systemic risk. The macro-level approaches of Nos. 4 and 5 can also play an important role in preventing the aggregation of credit in a nation's financial system, as happened in the current crisis.

There are, however, practical difficulties for the authorities in terms of deciding what criteria to use for defining an "excessive" aggregation of credit or an "excessive" reliance on specific funding methods. And without a convincing rationale, it would be difficult to stop the growth of credit at FIs. This issue is not specific to the ESRB recommendation and is applicable to all authorities in the developed nations.

Conclusion

The decision to present specific policy recommendation and deadlines for a problem—risks posed by foreign currency lending—represents a significant step forward for the ESRB. At the same time, the recommendation is little more than a reflection of the problems faced by developed nations today in preventing systemic risks.

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