ESRB
European Systemic Risk Board
European System of Financial Supervision

November 2013

ESRB Recommendation on lending in foreign currencies (ESRB/2011/1)
Follow-up Report– Overall assessment

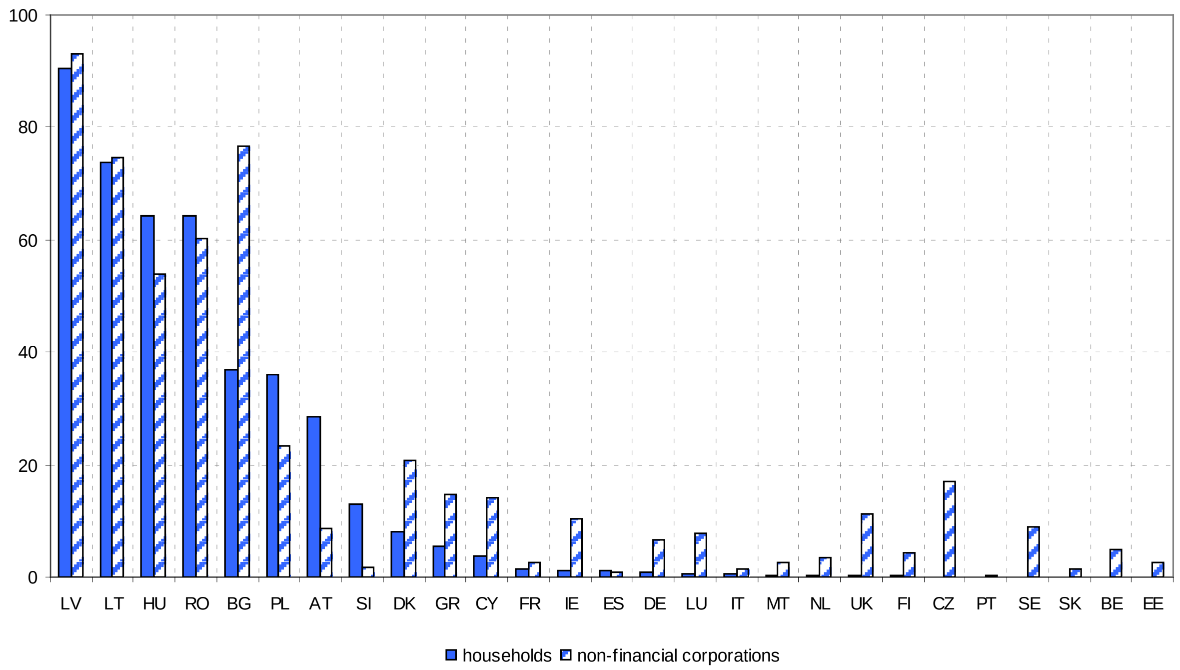
Introduction

This report provides the ESRB assessment of the implementation of Recommendation ESRB/2011/1 on lending in foreign currencies[1] (hereinafter the 'Recommendation'). The deadline for the addressees to provide information on the level of implementation was 30 December 2012. Additional information was collected on a voluntary basis in July 2013. This information was also taken into consideration in the assessment.

Recommendation ESRB/2011/1 contains seven sub-recommendations (marked with letters from 'A' to 'G'). The report contains a detailed assessment of the implementation for each of them by 27 Member States of the European Union. Croatia was not included in the assessment. An assessment of its implementation of the Recommendation will be carried out separately.

The Recommendation also contains an economic Annex, which documents the level of foreign exchange lending in the Member States. Chart 1 is drawn from the Annex and refers to April 2011 data.

Chart 1 - Foreign exchange lending to households and non-financial corporations in EU27



Source: ECB balance sheet item statistics and own calculations.
Notes: This chart depicts foreign exchange lending by monetary financial institutions to resident counterparties, as % of total outstanding loans, April 2011.

Verification of the Recommendation's implementation was carried out following the so-called 'act or explain' mechanism, where the addressee of a recommendation can either (i) take action in response to a recommendation and inform the ESRB of such action; or (ii) take no action to implement the recommendation but properly justify the reasons for inaction. The ESRB subsequently analyses the information provided and verifies whether the actions taken duly

[1] OJ C 342, 22.11.2011, p. 1.

achieve the objective of the recommendation or whether the justification provided for inaction is sufficient. This analysis results in a grade assigned to each Member State[2].

Positive grades	Mid-grade	Negative grades
Fully compliant (FC) – Actions taken fully implement the recommendation	**Partially compliant (PC)** – Actions taken only implement part of the recommendation	**Materially non-compliant (MNC)** – Actions taken only implement a very small part of the recommendation
Largely compliant (LC) – Actions taken implement almost all of the recommendation		**Non-compliant (NC)** – Actions taken are not in line with the nature of the recommendation
Sufficiently explained (SE) – No actions were taken but the addressee provided sufficient justification		**Inaction insufficiently explained (IE)** – No actions were taken and the addressee did not provide sufficient justification

The colour coding above allows the reader to understand the meaning of the different types of grades assigned.

The assessment was conducted at three levels:

(1) each individual section of the sub-recommendations;

(2) each sub-recommendation;

(3) the overall degree of the Recommendation's implementation by Member States Recommendation[3].

For additional information on the grading system, please refer to Section 4 of the Handbook on the follow-up to ESRB recommendations[4]: This document was approved by the General Board in April 2013 and aims to be the guiding tool for all future assessment teams. This follow-up report is the first time that the Handbook has been utilised.

A number of ESRB member institutions were actively involved in assessing the Recommendation's implementation. None of them, however, were directly involved in grading their own country's performance. The assessment of the Recommendation's implementation was

[2] Recommendation ESRB/2011/1 limits the possibility for addressees to explain their inaction to a certain extent. For instance, the Recommendation refers to the principle of proportionality to ensure that measures are taken in those economies where the level of foreign exchange lending to unhedged borrowers could create a systemic risk, also based on the global size of the outstanding loans. At the same time, the Recommendation states that the principle of proportionality cannot be invoked to justify inaction with regard to some sub-recommendations, i.e. sub-recommendations A and G and explains the reasoning for this exception. The ESRB also wants to prevent new adverse developments in those economies where, up to this point in time, foreign exchange lending to unhedged borrowers has been fairly limited.

[3] The assessments took the form of a 'bottom up' process, where grades assigned to the detailed individual sections of the Recommendation were used to compute the overall assessment on Member States. There has, however, been some flexibility. In general, more weight was given to the weakest spots in a countries' performance when computing the average final assessment. However, for recommendation G, where non-compliance was most probably due to a defect in the original design of the Recommendation, non-compliance was not included in the computation of the average.

[4] The Handbook is published on the ESRB website at www.esrb.europa.eu.

based on each Member States' own submissions that were submitted to be evaluated by experts from ESRB member institutions in two different countries. The overall level of the Recommendation's implementation has been high. Pursuant to the information provided, no country received a non-compliant grade. Twelve countries were assessed as fully compliant, fourteen countries as largely compliant and one as only partially compliant.

For easier understanding, a table showing the overall level of implementation per sub-recommendation is included on page 5.

Nevertheless, two further actions are necessary.

First, the assessment took place at a time when financial activity was well below historical averages in many economies, due to a compression of both demand and supply of credit after the eruption of the financial crisis. In other terms, economic conditions have not yet materialised that could lead to a revamp of foreign exchange lending to unhedged borrowers, which could in turn trigger new systemic vulnerabilities. Thus the effectiveness of Recommendation ESRB/2011/1 has not yet been fully proven. In fact, this is shown by authorities persistently referring to the current low level of new foreign exchange lending to justify their lack of action. The widespread reference to the principle of proportionality to justify inaction reveals that the need for macro-prudential action remains limited.

Therefore, there will need to be a repeat assessment of the Recommendation's implementation in a few years, when economic activity and credit conditions should be more robust. The ESRB will continue monitoring developments and decide when a new assessment is necessary.

Second, the assessment has shown that there is still scope for immediate action with regard to information exchanges between national supervisory authorities. Sub-recommendation G, which created a mechanism for transmission of information between home and host authorities and to the ESRB and EBA on measures to address vulnerabilities, has only been partially successful. While there is evidence that information exchanges took place in colleges of supervisors, an ESRB-wide multilateral mechanism to share publicly available macro-prudential information seems warranted.

In many respects, the failure to fully implement sub-recommendation G is due to the complexity of the initial design for implementing information exchanges, including the lack of a centralised hub. A procedure based on the use of the ESRB website is being established. However, it cannot be ignored that, in some cases, the lack of bilateral communication channels may show that authorities have given insufficient attention to possible cross-border spillover.

Colour shade table

This table shows, at a glance, the Recommendation's overall implementation level:

Country	A	B	C	D	E1	F	G	Overall
Belgium	LC	LC	SE	SE	LC	FC	IE	LC
Bulgaria	PC	PC	SE	PC	LC	FC	SE	PC
Czech Republic	SE	SE	FC	SE	SE	FC	SE	FC
Denmark	SE	SE	SE	FC	FC	FC	IE	LC
Germany	LC	SE	FC	FC	SE	FC	SE	FC
Estonia	FC	SE	FC	LC	FC	SE	SE	FC
Ireland	SE	LC	FC	SE	SE	LC	SE	LC
Greece	FC	SE	SE	SE	SE	SE	FC	FC
Spain	LC	SE	SE	FC	FC	FC	SE	FC
France	IE	SE	FC	SE	SE	FC	SE	LC
Italy	LC	SE	SE	SE	SE	SE	FC	LC
Cyprus	SE	LC	FC	SE	LC	FC	SE	LC
Latvia	SE	LC	FC	LC	LC	FC	SE	LC
Lithuania	LC	LC	FC	FC	PC	LC	SE	LC
Luxembourg	FC	FC	FC	FC	FC	FC	SE	FC
Hungary	FC	FC	FC	FC	PC	FC	SE	LC
Malta	FC	FC	FC	FC	FC	FC	FC	FC
Netherlands	SE	SE	SE	SE	SE	SE	SE	LC
Austria	FC	FC	FC	FC	FC	FC	FC	FC
Poland	FC	FC	FC	FC	FC	FC	SE	FC
Portugal	FC	FC	SE	SE	SE	FC	SE	FC
Romania	LC	FC	FC	FC	FC	FC	FC	FC
Slovenia	LC	LC	SE	SE	SE	LC	SE	LC
Slovakia	FC	SE	SE	SE	SE	SE	SE	FC
Finland	SE	SE	SE	SE	SE	SE	SE	LC
Sweden	SE	LC	SE	FC	SE	SE	SE	LC
United Kingdom	SE	SE	SE	LC	SE	LC	LC	LC

Assessment

1. Objective of the Recommendation

Pursuant to Article 16 of Regulation (EU) 1092/2010 of the European Parliament and of the Council of 24 November 2010 on the European Union macro-prudential oversight of the financial system and establishing a European Systemic Risk Board[5], the ESRB shall issue recommendations for remedial action when a significant systemic risk is identified.

Accordingly, the Recommendation was issued, proposing a series of measures to tackle the significant systemic risks that foreign exchange lending could pose. These measures intend to:

(i) limit exposures to credit and market risks, thus increasing the resilience of the financial system;

(ii) control excessive foreign currency credit growth and avoid asset price bubbles;

(iii) limit funding and liquidity risks;

(iv) create incentives to improve risk pricing associated with foreign exchange lending;

(v) avoid circumvention of national measures through regulatory arbitrage.

These measures are introduced to improve the resilience of the financial institutions providing this type of loan and thus shield the whole financial system against negative developments in exchange rates. The measures also have the positive side effect of increasing the level of consumer protection.

2. Overall level of the Recommendation’s implementation

As mentioned, the overall level of the Recommendation’s implementation is high. Almost all of the Member States (26) were considered to fulfil the requirements of the Regulation in full or at least to a very large extent. Only one Member State was considered as only partially implementing the Recommendation and no Member State was categorised as non-compliant.

The table below shows the grades assigned to each Member State:

Fully or largely compliant	Partially compliant
BE, CZ, DK, DE, EE, IE, EL, ES, FR, IT, CY, LV, LT, LU, HU, MT, NL, AT, PL, PT, RO, SI, SK, FI, SE, and UK	BG

2.1 Level of implementation of sub-recommendation A

Sub-recommendation A requested national supervisory authorities or Member States to:

(i) require financial institutions to provide their borrowers with sufficient information to enable them to know the risks involved in this type of loan and to take a well-informed decision; and

5 OJ L 331, 15.12.2010, p. 1.

(ii) encourage financial institutions to offer domestic currency loans together with foreign exchange loans, as well as financial instruments to hedge against the risks.

This sub-recommendation does not only aim at protecting consumers; it also follows a precise macro-prudential objective: when consumers take well-informed decisions, it is in the interest of the economy as a whole. Institutions will also face less credit risks, since by having this knowledge, their borrowers should only take on those risks that they consider manageable.

It is worth noticing that the principle of proportionality is expressly excluded from sub-recommendation A. Hence, addressees cannot justify their inaction in implementing this sub-recommendation by simply alleging that the level of foreign exchange loans is limited in material terms and thus these measures are not relevant in their country. As explained above, establishing a functioning regime of consumer protection is seen as a first line of defence, to prevent foreign exchange lending to unhedged borrowers from becoming an acute problem in countries that have not experienced this problem up to this point in time. Likewise, in accordance with the proposed Mortgage Credit Directive[6], as well as the already existing Consumer Credit Directive[7], the ESRB does not consider that the implementation of the first part of this sub-recommendation poses any major challenges for the addressees.

As regards the level of implementation, 16 Member States were considered to have followed sub-recommendation A in full or to a very large extent. Nine Member States sufficiently explained their lack of action.

However, Bulgaria (BG) was considered as only partially compliant since their authorities have stated that the euro should not be treated by domestic prudential regulation as a foreign currency, due to the country's foreign exchange regime. Bulgaria was therefore considered as fully compliant on foreign currencies loans, but not with regard to euro denominated loans.

Finally, the inaction of a Member State was considered as 'inaction insufficiently explained'. This was due to the second part of this sub-recommendation, which requires national authorities to encourage institutions to offer consumers a loan in their national currency, so that they would not be constrained to take over foreign currency liabilities due to absence of alternative financial products. French authorities saw no need for any measures to be taken, since the limited use of foreign exchange lending proves that equivalent domestic currency loans are already offered. While this is most probably true, the ESRB would like to request a more active stance by authorities, in line with sub-recommendation A.

The table below shows the grades assigned to each Member State:

Fully or largely compliant	**Inaction sufficiently explained**	**Partially compliant**	**Inaction insufficiently explained**
BE, DE, EE, EL, ES, IT, LT, LU, HU, MT, AT, PL, PT, RO SI and SK	CZ, DK, IE, CY, LV, NL, FI, SE and UK	BG	FR

2.2 Level of implementation of sub-recommendation B

Sub-recommendation B requested national supervisory authorities to:

[6] Proposal for a Directive of the European Parliament and of the Council on credit agreements relating to residential property (Mortgage Credit Directive)/ COM/2011/0142 final.

[7] Directive 2008/48/EC of the European Parliament and of the Council of 23 April 2008 on credit agreements for consumers (OJ L 133, 22.5.2008, p. 66).

(i) monitor the level of foreign exchange lending and adopt the necessary measures to reduce it;

(ii) to only permit foreign exchange currency loans to be granted to those borrowers that demonstrate their creditworthiness;

(iii) consider setting more stringent underwriting standards, e.g. loan-to-value ratios.

This sub-recommendation is intended to increase the resilience of the financial system against negative developments with interest rates that might affect a borrower's capacity to repay a loan. This is done in two ways:

(i) by only allowing loans to be granted to borrowers that are expected to be able to repay them; and

(ii) by imposing measures to tackle excessive levels of foreign exchange lending.

The implementation of this sub-recommendation is very high. Fourteen Member States were considered to have followed sub-recommendation B in full or to a very large extent. Twelve Member States sufficiently explained their lack of action, mainly relying on the low levels of foreign exchange lending.

Only Bulgaria partially implemented this sub-recommendation, giving the same reasoning explained above.

No Member State has been categorised as non-compliant and no inaction has been considered insufficiently explained.

The table below shows the grades assigned to each Member State:

Fully or largely compliant	Inaction sufficiently explained	Partially compliant
BE, IE, CY, LV, LT, LU, HU, MT, AT, PL, PT RO, SI and SE	CZ, DK, DE, EE, EL, ES, FR, IT, NL, SK, FI, and UK	BG

2.3 Level of implementation of sub-recommendation C

Sub-recommendation C requested national supervisory authorities to monitor whether foreign exchange lending is inducing excessive credit growth. If this is found to be the case, then these authorities were asked to adopt more stringent measures than the ones recommended under sub-recommendation B.

Compared to the previous sub-recommendation, whose purpose was to prevent an excessive cyclical development of credit growth, sub-recommendation C was written against the background of already significant cyclical developments that would therefore require a stronger counter-cyclical response by authorities.

There was widespread evidence of monitoring. All Member States were considered either fully compliant with sub- recommendation C or, if they did not implement any measure, their inaction was considered sufficiently explained.

Likewise, no Member States were categorised as non-compliant and any inaction on their part was considered sufficiently explained.

It goes without saying, however, that as previously mentioned, dynamics leading to excessive credit growth are improbable in the current situation. This sub-recommendation, on the other hand, was not written to cope with insufficient credit provision for foreign currency. Therefore, it may be difficult to activate its second part at the current juncture.

The table below shows the grades assigned to each Member State:

Fully or largely compliant	Inaction sufficiently explained
CZ, DE, EE, IE, FR, CY, LV, LT, LU, HU, MT, AT, PL, and RO	BE, BG,DK, EL, ES, IT, NL, PT, SI, SK, FI, SE and UK

2.4 Level of implementation of sub-recommendation D

Sub-recommendation D requested national supervisory authorities to address guidelines to financial institutions in their jurisdictions, so that foreign exchange lending risks are better incorporated into their internal risk management systems. These guidelines should cover internal risk pricing and capital allocation.

The recommended measures should also create incentives for institutions to better identify the risks associated with foreign exchange lending and internalise its potential costs.

The response to this sub-recommendation was also very positive. Almost all Member States implemented measures that follow the provisions sub- recommendation D in full or to a very large extent or, if they did not implement any measure, their inaction was considered sufficiently explained.

Only one country, Bulgaria, was considered partially compliant with regard to actions taken, for similar reasons to those mentioned above.

No Member States were categorised as non-compliant and any inaction on their part was considered sufficiently explained.

The table below shows the grades assigned to each Member State:

Fully or largely compliant	Inaction sufficiently explained	Partially compliant
DK, DE, EE, ES, LV, LT, LU, HU, MT, AT, PL, RO, SE and UK	BE, CZ, IE, EL, FR, IT, CY, NL, PT, SI and SK and FI	BG

2.5 Level of implementation of sub-recommendation E

Sub-recommendation E requested national supervisory authorities to implement specific measures under Pillar II and, in particular, to require financial institutions to hold adequate capital to cover risks associated with foreign exchange lending. The European Banking Authority (EBA) was also requested to issue guidelines to national supervisory authorities to guide the application of capital requirements for foreign exchange lending risks.

The goal of this sub-recommendation is to 'adjust' the pricing of foreign exchange lending risks. This higher capital increases the resilience of the system against negative shocks, given the higher loss-absorbing capacity of the institutions.

Responding to the respective recommendation, the EBA launched a consultation on proposed guidelines on 23 May 2013[8]. The ESRB responded with a public document[9] that offered some advice, while also stating that the content of the proposed guidelines closely follows sub-recommendation E(2).

On the other hand, 12 Member States were considered to follow sub-recommendation E1 in full or to a very large extent. Thirteen Member States sufficiently explained their lack of action, mainly relying on the low levels of foreign exchange lending.

Hungary was only considered partially compliant, since Hungarian authorities state that foreign exchange lending risks are already considered in the Supervisory Review and Evaluation Process. However, due to the high level of foreign exchange lending in this Member State, the ESRB considers that special capital add-on addressing foreign exchange lending should be effectively implemented. Lithuania was also considered only partially compliant since Lithuanian authorities treat lending in euro as similar to lending in domestic currency for these purposes.

No Member States have been categorised as non-compliant, nor has any inaction been considered as insufficiently justified.

The table below shows the grades assigned to each Member State:

Fully or largely compliant	Inaction sufficiently explained	Partially compliant
BE, BG, DK, EE, ES, CY, LV, LU, MT, AT, PL and RO	CZ, DE, IE, EL, FR, IT, NL, PT, SI, SK, FI, SE and UK	LT and HU

2.6 Level of implementation of sub-recommendation F

Sub-recommendation F requested national supervisory authorities to monitor funding and liquidity risks taken by financial institutions in connection with foreign exchange lending, together with their overall liquidity provisions.

Given that short-term funding normally costs less than long-term, institutions may tend to obtain excessive short-term funding, entering into refinancing risks which could be exacerbated by foreign exchange volatility. This sub-recommendation intends to address the problem by limiting refinancing and concentration risks in order to achieve more sustainable levels of maturity mismatches and resilience to negative developments in the funding markets.

Almost all Member States have implemented measures that follow the provisions of sub-recommendation F fully or to a very large extent or, if they did not implement any measure, their inaction was considered sufficiently explained.

The table below shows the grades assigned to each Member State:

[8] See Consultation Paper on Draft Guidelines on Capital Measures for Foreign Currency Lending to Unhedged Borrowers under the Supervisory Review and Evaluation Process, 23 May 2013 (EBA/CP/2013/20), available on the European Banking Authority's website at www.eba.europa.eu.

[9] See Response from the ESRB to the EBA Consultation Paper on Draft Guidelines on Capital Measures for Foreign Currency Lending to Unhedged Borrowers under the Supervisory Review and Evaluation Process, 23 August 2013, available on the European Banking Authority's website at www.eba.europa.eu.

Fully or largely compliant	Inaction sufficiently explained
BE, BG, CZ, DK, DE, IE, EL, ES, FR, CY, LV, LT, LU, HU, MT, AT, PL, PT, RO, SI, and UK	EE, IT, NL, SK, FI and SE

2.7 Level of implementation of sub-recommendation G

Sub-recommendation G requested that:

(i) national supervisory authorities of relevant financial institutions' home Member States impose measures addressing foreign exchange lending that are, at a minimum, as stringent as the measures imposed by the host supervisor; and

(ii) national supervisory authorities of the home Member States publish the measures taken by the relevant host supervisors on their websites. In order to allow this to take place, national supervisory authorities of the host Member State were recommended to communicate the relevant measures to the home supervisors, to the EBA and the ESRB.

The main objective behind this sub-recommendation is to avoid regulatory arbitrage and the circumvention of the measures implemented after the Recommendation, by making all stakeholders aware of measures taken by the relevant authorities.

As explained above, the assessment demonstrated that there is still scope for action with regard to information exchange between national supervisory authorities. Sub-recommendation G, which had created a mechanism for transmission of information between home and host authorities and to the ESRB and EBA as regards national prudential measures to address vulnerabilities, has been only partially successful. While there is evidence that information exchanges took place in colleges of supervisors, an ESRB-wide, macro-prudential mechanism for transmission of information seems warranted.

Accordingly, only six Member States (Greece, Italy, Malta, Austria, Romania and the United Kingdom) were considered to have followed sub-recommendation G in full or to a very large extent. Nineteen Member States sufficiently explained their lack of action, even though some of them heavily relied upon information obtained in the colleges of supervisors.

The justification for lack of action in the case of the remaining two Member States was considered insufficient. The main reason behind this grade was inaction by the authorities with regard to the second part of this sub-recommendation, i.e. information exchange between host authorities to home authorities, and publication on their websites. Some of them expressly requested the ESRB to establish a centralised hub for the transmission of information. Even though the ESRB agreed to this request, setting this platform was not originally part of this sub-recommendation.

As mentioned above, a more multilateral mechanism for information exchange and publication is being prepared.

The table below shows the grades assigned to each Member State:

Fully or largely compliant	Inaction sufficiently explained	Inaction insufficiently explained
EL, IT, MT, AT, RO and UK	BG, CZ, DE, EE, IE, ES, FR, CY, LV, LT, LU, HU, NL, PL, PT, SI, SK, FI, and SE	BE and DK

Kindly note that, as mentioned above (see footnote 3), in order to grade the overall assessment of Recommendation ESRB/2011/1's implementation by each Member State, the degree to which sub-recommendation G was followed was not taken into account because it was recognised that the proposed bilateral mechanisms could be too complex, and replacing them with a centralised hub procedure involving the ESRB could be a more efficient option, as requested by some Member States when reporting on their implementation of sub-recommendation G[10].

[10] The approach followed to grade the overall implementation of the recommendation was not completely mechanical. The ESRB strived to guarantee a level playing field, among the different Member States, by applying a certain level of judgment when taking the final decision.