A Zloty Trouble in Foreign Currency Loans

Back in the 1980s, quite a few Australian borrowers took on mortgages denominated in Swiss francs and/or Japanese yen, usually egged on by their banker. Aussie dollar mortgages had sky high interest rates at the time, whereas rates were lower in Switzerland and Japan. If those overseas rates stayed low, and if the Australian dollar didn't weaken, borrowers would save a fortune.

Want to know how it turned out? Well, it is now referred to as the foreign currency loan scandal for a reason. Thanks to large fall in the Australian dollar's value, more affordable interest repayments soon became extremely expensive, outstanding debts ballooned in local currency terms and people's homes and farms were quickly imperilled or lost.

One problem with foreign currency loans is that the risk is binary – if they go right, you save a few bob (or francs, or yen) on interest. If they go wrong, you blow up. Another is that interest rate parity suggests, at least in theory, that there is no free lunch there anyway, except maybe for your friendly banker. It's a mirage, with fees (a country with higher interest rates should see its exchange rate depreciate by an amount equivalent to the differential with a lower rate country).

Unfortunately, and all too predictably, it's a situation that has played out time and again. It seems national mortgage and other financial markets are incapable of learning vicariously.

Each geography and each generation wants to make its own mistakes. So does each banker. Around the time Baby Boomer Aussie foreign currency borrowers and banks were learning their lesson, so too were Germans, Austrians and many others.

A few decades later, some of those same central European banks caught up in the 1980s and 1990s scandals in their home lending markets were up to it again in Eastern Europe.

Behind the Financial Times paywall is an article describing how Polish borrowers were sold Swiss franc mortgages by Austrian, Italian, Spanish and Dutch banks in the mid-2000s, which subsequently went bad. Poland is looking to follow in the footsteps of Hungary (where similar practices were present) in helping claw back some of the mortgagees' losses from the banks.

I'm not writing to comment on that political/legal hot potato, nor to analyse how it might affect those European banks (which we've avoided). Rather, it is to make the general and obvious reminder that all free lunches are worthy of great suspicion.

Just a few years ago, a European friend of mine was discussing taking out some part of his mortgage in francs rather than euros. He's a trained engineer—so he understands the margin of safety concept intuitively. He also wears a helmet on the ski slopes. And yet he still found the concept enticing. I discussed with him the binary nature of the risk. Fortunately he passed, as the EUR/CHF is down at least 25% since then. His wariness meant his annual interest bill cost more in Euro, but he avoided a ballooning principal balance a few years later.

Unbelievably, the same Austrian banks were having yet another crack at selling foreign currency loans.

As the forever erudite James Grant once opined:

"*Progress is cumulative in science and engineering, but cyclical in finance.*"