THE WALL STREET JOURNAL. ONLINE

May 29, 2007

PAGE ONE

TRADING UP

Homeowners Abroad Take Currency Gamble in Loans

Foreign Denomination Can Mean Lower Rates; Mr. Fekete's Gyrations

By CRAIG KARMIN and JOELLEN PERRY
May 29, 2007; Page A1

BUDAPEST -- Tamas Bencze got a rude surprise when he ripped open his mortgage statement last summer. In just two months, the payment on his three-bedroom home here had jumped 10%.

"My wife looked at our mortgage and asked me, 'What's happening?'" he says.

MORTGAGE CALCULATOR

- **The Situation:** Homeowners in Eastern Europe are taking out mortgages in currencies from other countries to get lower interest rates.
- **The Gamble:** Currency fluctuations can have a huge impact on monthly payments, and some fear such loans pose a broader risk to the economy.
- **The Background:** Banks are offering such transactions, which are similar to 'carry trades' by big hedge funds, because they boost their profit margins.

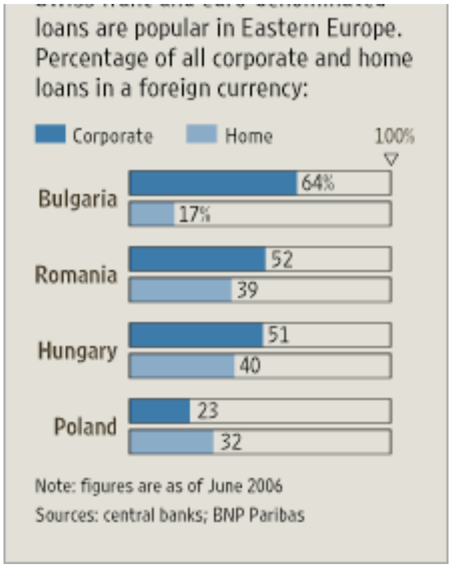
Mr. Bencze got burned playing a risky game: He had taken out a mortgage in a foreign currency, lured by lower interest rates abroad. Everything was fine until exchange rates suddenly shifted, causing his monthly payment to rise.

Financial strategies like these -- borrowing cheaply in one country to invest in a higher-yielding asset somewhere else -- are usually a game for big-money speculators like hedge funds and Wall Street traders. The maneuver is known as the "carry trade," because in banking lingo the difference between two interest rates is the "carry."

The carry trade has surged as relatively low interest rates in many parts of the world have forced investors to look for new ways to boost yield. At the same time, volatility among currencies is also near historic lows, reducing the apparent risk.

Now, across Eastern Europe, millions of people like Mr. Bencze are literally betting the house in their own version of the carry trade. They're taking advantage of low interest rates for loans in euros or Swiss francs.

But they may be in for a wilder ride than they expected. If exchange rates swing sharply, borrowers could be



hard-pressed to pay back their loans. Mr. Bencze's loan is denominated in Swiss francs, while he makes monthly payments in his own currency, Hungarian forints. When the Swiss franc rises, he must pay more forints to cover the difference. While large investors and institutions can buy derivatives to offset currency risk on large international transactions, that option isn't available to most individual homeowners with their much smaller loans.

In Poland, a third of all mortgages are in foreign currencies, up from almost none a few years ago. The Swedish bank SEB says that up to 70% of its lending in Latvia is in euros instead of the local currency, the lats. In Hungary, half of mortgages are foreign-currency denominated, according to the central bank, as well as a big chunk of car and small-business loans.

"Everyone's a bit of a gambler," says Mr. Bencze, a financial analyst at a leasing company, who also has had a Swiss-franc car loan. His mortgage charges 5.75% -- well below the 14% an equivalent Hungarian forint mortgage would cost.

The sort of surprise that hit Mr. Bencze last summer can also shake the world economy. On Feb. 27, the unraveling of carry trades by big investors, many involving bets made with borrowed money, contributed to the U.S. stock market's biggest one-day decline in four years.

Governments worry that investors, big and small, may have become heedless of the potential for wide currency swings. In Hungary, the scenario drawing concern involves a sudden drop in the forint, which could unleash housing-market mayhem and spill over to the broader economy.

Hungary's central bank last year issued a report stating that foreign borrowing "poses substantial risk to financial stability." In January, the bank followed up with a survey of more than 1,000 foreign-currency mortgage holders to measure their awareness of the risks. Its conclusion: "Quite a huge number didn't have a clue what would happen," says Tamas Kalman, the Hungarian central-bank official who oversaw the research.

Tamas Kalman

Poland has gone a step further, issuing a directive last July intended to curb foreign loans. Poland is one of several countries, including Hungary and Latvia, where the foreign-currency debt coming due exceeds the government's foreign reserves. If foreign investors for some reason decided to pull their money out of these countries en masse, their currencies could be vulnerable.

Recently, Latvians got a taste of what a currency scare can look like. On Feb. 16, rumors spread rapidly that Latvia's currency was about to be devalued. (The lats is pegged to the euro.) Foreign-exchange booths across Riga, the capital, ran out of euros before lunchtime as Latvians rushed to

Tamas Kalman

convert their savings from lati into euros. The government denied the rumors but since then, the central bank has had to spend more than €300 million, or about $403 million -- roughly 10% of currency reserves -- defending the lats.

Credit-rating agencies are raising concerns as well. In March, Fitch Ratings examined the high levels of foreign-currency borrowing in Latvia, as well as neighboring Estonia and Lithuania, and made a direct comparison with the economies of Mexico and Asia in the 1990s before their financial crises.

The carry trade played a part in the Asian crisis that got rolling in Thailand in 1997. Thai corporations and banks had borrowed heavily in U.S. dollars to take advantage of lower interest rates. Then foreign lenders suddenly withdrew their credit, the Thai currency plunged, and Thais had trouble paying back the loans.

Despite the risks, people keep trying carry trades because they can be highly profitable. Goldman Sachs says one basic version -- selling the six currencies with the lowest interest rates, buying the six with the highest, and resetting the mix once a month -- has returned 19% annually since 1998.

Taking advantage of differences in interest rates is a foundation of finance. It's what banks do every day, "borrowing" money from depositors at low savings-account rates and lending it back out at higher rates. Today, the globalization of finance has made it easier for investors to exploit cross-border interest-rate differences using the carry trade.

In much of the developed world, interest rates are comparatively low. This is largely because countries such as the U.S. have been able to post solid growth while keeping inflation low. Some chalk up low inflation to globalization and the availability of cheap labor in places like China, while others say central-bank policy making has improved. In Japan and Switzerland, central banks have kept interest rates at rock-bottom levels to stimulate sluggish economies and keep prices from falling.

Meanwhile, interest rates are much higher across much of Eastern Europe, where economies are growing quickly and inflation is high, stoked by foreign investment and a race to catch up with Western living standards.

The foreign-currency mortgages in Eastern Europe are just one of the permutations of the carry trade that have emerged recently. In Britain, a few wealthy individuals are taking out mortgages in Japanese yen -- taking advantage of super-low interest rates in Japan -- to buy homes or investment properties in Florida.

Last year London businessman Chris Papa bought a seven-bedroom house in Kissimmee, Fla., not far from Walt Disney World, borrowing the equivalent of $240,000 in yen from Lloyds TSB Bank PLC. He's paying 2.85%, far below the rates for a similar mortgage in dollars or pounds.

Mr. Papa says he is aware of the hazards. "Obviously it concerns me quite a lot," he says, but "personally I felt it was a risk worth taking."

In Hungary, home ownership was fairly common even during the socialist era. After 1989, local governments often gave those living in public housing the chance to buy their residences at low prices. Also, the government subsidized mortgages so that people didn't have to pay double-digit interest rates. The result was a home-ownership rate that now stands at 92%, one of the highest levels in the world.

By 2003, the mortgage subsidies were gobbling up 10% of the federal budget in Hungary, and the government was forced to slash them. About a dozen banks rushed into the void, offering new foreign-currency loans with rates near the old subsidized ones.

For Hungarian banks, profit margins are wide. Swiss interest rates have hovered between 1% and 2%, while banks can offer mortgages to Hungarian borrowers at 5% to 6%, because that's still only about half the local interest rate. Hungary's banks are among the most profitable in Europe.

As for borrowers, they're happy simply to get the lowest rate possible. So far, they haven't been stung by any long-lasting dives in the forint. While the Hungarian currency fell last July, it later recovered all its losses and then some.

Balazs Benczedi, head of ING Asset Management in Hungary, has drawn on his professional smarts in deciding to take out two Swiss-franc mortgages. His logic: Hungary's economy is on the right track and the country eventually will qualify to adopt the euro, so the forint should generally strengthen, which would make his mortgages increasingly affordable.

Over the long term, he may be right. But there can be painful short-term hiccups. After a brief weakening of the forint this spring caused Mr. Benczedi's mortgage payment to jump 5%, he says, "I was quite angry."

Swings like these can sway consumer spending. Istvan Fekete, who works for **Suzuki Motor** Corp. in Budapest, took out a Swiss-franc auto loan in 2004 to buy an Alfa Romeo convertible. Since then, his monthly payments have swung from a low of 43,000 forints (about $231 at current exchange rates) to as much as 51,000 forints.

When the forint strengthened -- making his payments lower -- Mr. Fekete recalls feeling flush. "We would go out for a big family dinner," he says. And when the forint weakened? "The kids would get less ice cream."

The Hungarian central bank says most households have little savings to tide them over if the forint were to decline substantially. "People do not understand that now they need savings," says Gyorgy Mohai, deputy chief executive of the Budapest stock exchange.

So far, the worst fears have yet to materialize. In Poland, officials last July enacted "Recommendation S." It calls on banks to assess a borrower's ability to repay foreign-currency loans based on whether the borrower could afford the same loan in Polish zloty at higher interest rates. Recommendation S has slowed growth in foreign-currency lending a bit. In 2005 and 2006, demand for foreign-currency mortgages outstripped demand for home loans in zloty. But in the first quarter of this year, the growth rate of zloty mortgages was more than 16%, nearly double the rate for foreign-currency mortgages.

Hungarian officials including Mr. Kalman of the central bank have opposed government regulations like Poland's. The central bank points to new efforts to promote financial literacy among the public, including a pilot program in high schools to teach rudimentary finance.

In Hungary, the foreclosure rate is only about 1%, and banks are able to hedge against currency risk. "We have extremely fat margins," says Peter Kisbenedek, former CEO of Erste Bank Hungary, soon to be chief financial officer of **Erste Holding**, parent company of Austria's Erste bank, with branches throughout Eastern Europe. "We can fund the risk."

-- *Joanna Slater*

Write to Craig Karmin at craig.karmin@wsj.com[1] and Joellen Perry at joellen.perry@wsj.com[2]

URL for this article:
http://online.wsj.com/article/SB118040375753116750.html

Hyperlinks in this Article:
(1) mailto:craig.karmin@wsj.com
(2) mailto:joellen.perry@wsj.com