Risks associated with foreign currency loans

In the past, domestic German loans – meaning loan agreements between German parties subject to German law – have sometimes been granted to companies and to a limited extent also to private individuals in currencies other than the euro, with the aim of securing the beneficial interest rates prevailing in different monetary systems. The Swiss franc was an especially popular choice. German consumers are believed to owe more than seven billion euros in private loans which are denominated in foreign currencies, primarily in Swiss francs. The steep decline in the euro’s value against the franc following the Swiss National Bank’s decision to decouple the two currencies on 15 January 2015 has thus been a key catalyst for concerns about the use of foreign currency loans as a financing instrument. In addition to action taken by individual central banks, expectations around the stability of foreign currencies have been undermined by wider developments and unexpected events – recent examples include the steady decline of the euro against the US dollar and the depreciation of the rouble against the backdrop of the conflict in Ukraine – present serious challenges to parties to foreign currency loan agreements.

Genuine foreign currency debt – yes or no

When agreeing on a foreign currency loan, i.e. one where the loan is paid out or repaid in a currency other than the euro, attention must be paid to the type of foreign currency debt being agreed. With genuine foreign currency debt, the parties agree in the credit agreement that payment should be made exclusively in the foreign currency. This determination may also be made by implied agreement as long as the parties’ intention is clearly rooted in the contract.

If no such determination is possible, the foreign currency debt falls under section 244 subsection 1 of the German Civil Code (BGB), and the debtor has the option of settling the foreign currency debt also in euros (right to alternative performance). It is generally held that this also applies if the loan agreement is not subject to German law, but the foreign currency debt is payable in Germany (or in Europe). The exchange rate on the payment date is the relevant rate for converting the debt (section 244 subsection 2, BGB). This also applies to any enforcements, which are made on the basis of euro calculations in Germany (sections 803 et seq. of the German Code of Civil Procedure – ZPO), and for which the applicable exchange rate is the rate on the day the proceeds are paid to the creditor. The right to alternative performance is mostly not an issue in enforcement cases, since satisfaction of a claim can generally only be obtained in euros (sections 803 et seq., ZPO).

These legal provisions can be highly disadvantageous to one of the two parties depending on changes in the value of the foreign currency, and it is not possible to plan reliably for such changes. In the case of the Swiss franc, which has risen by up to twenty percentage points against the euro, the impact seems mostly to have been felt by borrowers, who now have to spend significantly more euros to settle their foreign currency debts. However, one may also imagine a scenario in which the lender of the foreign currency loan sees a collapse in value of the repayment currency. The statutory payment regulations under section 244 of the BGB in the event of set-off are a particularly tricky issue for lenders. Since set-off only becomes effective once the declaration has been received, but is retroactive to the point in time at which the claims to be set off were first offsettable against each other (section 389, BGB), a borrower seeking to offset can craft a strategy based on the euro exchange rate because the applicable exchange rate is the one prevailing at the time of the set-off declaration. The borrower could delay the declaration until the euro exchange rate has risen to the desired level, thereby significantly reducing the value of the lender’s loan claim. According
to one opinion in the literature, the borrower does – as a result of the retroactive effect of the set-off – not even have to worry about default interest nor damages for default if the claims to be set off were already offsettable before any default on the part of the borrower.

It is thus advisable for parties to foreign currency loan agreements to agree on a genuine foreign currency debt in the interests of predictability, and to expressly include details regarding the repayment and the applicable conversion rate in the loan agreement.

**Currency conversion clauses in private loans**

If banks require a contractual commitment that the borrower will bear the cost of repaying the loan in a certain currency, i.e. the cost of exchange rate fluctuations, this leads to calculation risks for the borrower which can be difficult to assess. Specifically in the consumer loan market, borrowers enjoy a high level of protection which is partly due to European law. Judicial controls on effectiveness of such conversion arrangements generally focus on the clause that governs the loan repayment. Under German law, such clauses are invalid if they lead to an unfair disadvantage for the customer, this legal concept arising from the law on terms and conditions and also contained in special statutory regulations, such as section 2 of the Price Clause Act.

The European Court of Justice (“ECJ”) recently specified what should be understood as unfair terms in a decision dated 30 April 2014 (Case C-26 / 13 – Kásler et. al. v OTP Jelzálogbank Zrt). This essentially involved a private loan to a Hungarian couple where the loan was advanced and to be repaid in Hungarian forints as per the agreement, but which was converted into Swiss francs in the bank’s internal bookkeeping system. The loan agreement specified that the rate of exchange to be used for conversion on the date of advance of the funds should be the buying rate. However, upon repayment the amounts in forint were to be converted using the currency’s selling rate.

With reference to the validity of the clause, the ECJ stated that there was a requirement for full transparency due to the consumer’s systematically lower level of information. The average consumer, who is reasonably well informed and aware, would have to be put in a position via information made available by the bank, including the promotional material and other information provided by the lender, to be aware of the difference between the selling rate of exchange and the buying rate of exchange of a foreign currency and of the potential negative impact on him. Furthermore he would also have to be capable of assessing the economic impact of this arrangement on him, which may be significant, and therefore the total cost of his loan. In the case in question, the ECJ decided that the bank had failed to provide the necessary information. The ECJ also decided that the Hungarian Court of Appeal could use dispositive national law to fill the contractual gap which resulted from the invalid clause.

The ECJ left unanswered the intriguing question as to whether the bank would also have to disclose the economic motivation for using the clause (this is not required under existing German legal doctrine).

**Economic risks of price fluctuations**

There are further economic risks in addition to the legal pitfalls already outlined. One might seek to hedge against these risks by means of executing currency swaps but since these are independent transactions they might present additional problems if subsequent changes lead to discrepancies between the rights and payments obligations under the loan agreement and the currency swap.

Further economic risks result from a potential increase in value of the foreign currency against the euro. This might lead to an increase in the basic value of the loan after its conversion back into euros, in which case the loan agreement (or the bank’s general terms and conditions) will often give rise to a claim for further collateral once an agreed threshold (of often 105%) is exceeded. This may prove difficult for the borrower to provide if it has no other suitable collateral available. This is all the more critical since an unfulfilled claim for further collateral will generally give rise to grounds for termination under the loan agreement.

The same applies if a certain loan-to-value-ratio or asset-value clause has been agreed, which is then exceeded due to exchange rate changes affecting the foreign currency, thereby providing grounds for
termination. In the case of loan-to-value-ratio clauses, this problem can be remedied by defining a fixed exchange rate. The risk of needing additional collateral can ultimately only be minimised with regard to short-term exchange rate fluctuations by agreeing that the exchange rate must exceed or fall below a certain threshold for a specified period. Example: The bank’s right to request additional security is only triggered if the loan amount converted at the current exchange rate exceeds the loan amount converted at the original exchange rate by 20% over a continuous period of six months.

Conclusion

Caution is required when entering into foreign currency loans. Careful structuring of the loan relationship in relation to currency liability is crucial both for the lender and the borrower in order to ensure predictability and the desired economic outcome. However, risks arising from unexpected changes in the value of the loan currency or ineffective price clauses can be largely minimised by careful drafting of the agreement.

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