Currency-Hedged Funds—Safer or Riskier Thanks to Derivatives?

Limits proposed on derivatives make it harder, more expensive to offset risk

By
Ben Eisen and
Sarah Krouse

A government proposal meant to limit the use of risky derivatives could hamper an increasingly
popular breed of mutual funds that hedge against currency risks.

Individual investors in recent years have flocked to mutual funds and exchange-traded funds that
try to minimize the impact of currency moves on their investments in foreign assets.

Now, rules being considered by the Securities and Exchange Commission to limit mutual funds’
use of derivatives broadly could make it harder, or more expensive, for the currency-hedging
funds to hedge their risk.

The proposed rules are meant to crack down on the increasing use of leverage in portfolios. Their
application to funds that hedge for currency risk is prompting pushback across the mutual-fund
industry, making the fledgling market a petri dish for the debate over limits on the use of
derivatives in mutual funds.

The SEC in its proposal said that it can be “difficult to distinguish purported hedges from
leveraged or speculative exposures” and typically takes feedback provided during comment
periods into account before issuing final rules.

“Currency-hedged” funds have lately attracted investors as a sharp rise in the dollar in 2014 and
2015 made investors more willing to pay to protect themselves against currency fluctuations.

A J.P. Morgan index that measures currency volatility has more than doubled from its recent low
in July 2014.

Many funds that invest in overseas assets hedge certain parts of their currency exposure. But the
growing stable of currency-hedged funds seek to weed out all of the risk associated with
swinging currencies.

Total assets in bond mutual funds benchmarked to the currency-hedged Barclays Global
Aggregate Bond Index, for example, have grown by more than 32% during the year through
March to $10.1 billion, according to fund-data tracker Morningstar Inc.
Currency-hedged ETFs also have become increasingly popular, with money managers starting 28 new products in 2015, up from 10 the prior year and five in 2013, according to Morningstar.

To hedge against currency fluctuations, funds use derivatives such as forward contracts, which are agreements to buy or sell a specific currency at a future date at a preagreed rate.

The hedging can be costly and eat into performance. The unhedged Barclays index has risen 5% over the past year, compared with 2.6% on the hedged index, according to Morningstar. The unhedged global bond fund of Pacific Investment Management Co., or Pimco, has returned 6% so far this year, while the hedged counterpart returned 2.6%, according to the firm’s website.

As currently proposed, the rules would put caps on the amount of leverage funds can obtain through derivatives. The proposed rules also would require that managers hold cash or cash equivalents in amounts sufficient to pay obligations that may be triggered by their derivatives contracts. Having cash on hand can prevent funds from having to sell securities, potentially at fire-sale prices, to make payments when these hedges move against them.

Some fund managers argue that the cash-holding requirements shouldn’t apply to derivatives meant to reduce risks to investors.

Douglas Hodge, chief executive of Pimco, said in the firm’s comment letter on the proposed rules that regulators shouldn’t count derivative exposures that reduce currency risks. “This would effectively exclude currency derivatives that reduce risk, while including currency derivatives that add risk to the portfolio,” he wrote last month.

BlackRock Inc. and Vanguard Group echoed those concerns, telling the agency in March that the proposed rules would lead to funds holding more cash that could weigh on performance and potentially lead to tracking errors.

When a fund is required to hold cash, its performance can lag behind the benchmark it is meant to track or beat or limit losses in a down market. That is because cash and equivalent assets don’t earn the same returns as other riskier securities.
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International Business

Homeowners in Poland Borrowed in Swiss Francs, and Now Pay Dearly

By DANNY HAKIM

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WARSAW — Piotr Szczepaniak, an apartment manager here, had just finished work, checking faucets and making sure rents were paid. After making himself a coffee, he logged on to a Polish social network and noticed that someone had posted the current exchange rate of the Swiss franc.

“I was frozen,” he said, seeing that the franc’s value had soared that day. Like hundreds of thousands of other Eastern Europeans, Mr. Szczepaniak, 46, is paying off a mortgage he took out in francs, instead of his local currency, the zloty.

In an instant, his monthly payment rose by more than 20 percent when Switzerland’s central bank unexpectedly removed a cap on its currency.

Central bankers are increasingly viewed as wizards capable of rescuing countries from the doldrums by printing money to manage interest rates and control currencies. But the monetary magic is unleashing unintended consequences on the global economy, financial markets and ordinary people.

The action by the Swiss central bank, which came in mid-January, was one of the biggest surprises. The Swiss National Bank decided it would be hard-pressed to keep the franc tied to the euro when the European Central Bank began a major round of stimulus.

The move set off shock waves in financial markets and a one-day 23 percent spike in the franc’s value against the euro.

The fallout has been far-reaching. Some hedge funds, like one run by the Fortress Investment Group, took steep losses; the IG Group, a publicly traded British brokerage firm and financial trading company, issued a profit warning. Swiss exporters howled, and the chief executive of the watchmaker Swatch Group called it a “tsunami.”

Many of the worst hit are average Europeans who took out loans in Swiss francs, often from foreign-owned banks, to take advantage of the far lower interest rates being offered.

Poland has nearly $40 billion in loans denominated in francs, according to European Central Bank data. The borrowing, which accounts for nearly 8 percent of the country’s gross domestic product, has left Poland weighing its options. On Wednesday, the Polish government urged banks to convert franc loans to zloty at market rates.

Poland is hardly the only country in this predicament. Austria has about $41 billion worth of such loans, close to 10 percent of its economic output. Other ordinary borrowers, from France to Croatia, have also felt the sting.
“With hindsight, it’s easy to say the foreign banks are guilty of pushing these mortgages and not informing customers of the risks,” said Nicholas Spiro, managing director of Spiro Sovereign Strategy in London, who also blamed “insufficient regulation.” Poland’s troubles, which come during an election year, are “political dynamite,” he added.

Before the financial crisis gripped Europe, banks heavily marketed loans in Swiss francs, which were available at interest rates a third as high as for loans in Polish zlotys, or even lower. In Poland, there were 562,487 home loans in francs in 2013, representing almost a third of the total number of mortgages, according to the Polish Financial Supervision Authority.

Poland is a country that is still getting used to the idea of mortgages. Many Poles who took out loans were the first in their family to do so.

“It was quite a shock for my parents,” said Rafał Jackowski, 39, a marketing executive who took out a loan in francs for an apartment in Krakow in 2004.

“They said, ‘My God, you can pay that much?’” he said, adding, “We were not used to spending money that we don’t have.”

But borrowers unknowingly became amateur currency traders in a fast-moving game that has affected many professionals.

Mr. Szczepaniak, married and the father of a 13-year-old boy, recently joined a Facebook support group whose name translates to “Tricked Into Francs,” where he exchanges stories with other Poles.

“They are terrified, they are scared, and they pray that the government does something,” he said. On a recent morning, his son, Krzysztof, was watching the Disney Channel dubbed into Polish while Mr. Szczepaniak showed a chart of the movement of the franc against the zloty since he took out his loan in 2003.

“It didn’t seem scary at the time,” he said. “Both the Polish and Swiss economy were very stable, and the foreign exchange rates were predictable.”

Since then, the franc’s relative value has increased more than 40 percent.

In many ways, he is lucky. He took out his mortgage relatively early in the cycle. He said he got a 4.65 percent loan in francs, versus the 10 to 12 percent he would have paid in zlotys at the time. He can afford the increase, which amounts to $70 a month.

Others are in far deeper trouble.

Katarzyna Szczersowska, a 43-year-old writer, said she was advised by a financial consultant when she bought a two-story apartment in 2008.

“The adviser said Swiss francs were the best option because the interest rates were lower and the currency rates were stable,” she said.

“Everybody around me advised me to take a mortgage in Swiss francs,” she added. “Everybody else was doing the same thing.”
She says she is now so far behind on her payments, and feels so trapped by her accumulating debts, that she has contemplated suicide.

She learned on Facebook of the Swiss central bank's action the morning it happened. She immediately began calling her bank and kept calling all day, but could not get through.

Over the last five years, her payments have doubled to about $2,000 a month. A few months ago, her boyfriend — the father of her 20-year-old daughter — went abroad to help cover the added costs by getting a job in a factory.

When she first took out her loan, the United States was already in the grip of a financial crisis, but its impact on Europe was still not clear.

"Everybody kept saying that the crisis in the States was very local — nobody knew why — but it was the U.S. that had problems," Ms. Szczerezowska said. "People had to be idiots to think the crisis wouldn't spread. Unfortunately, I was the idiot."

Because Poland also had a housing bubble that collapsed during the crisis, many who borrowed in francs are now underwater.

Leszek Wolany bought a small house in Warsaw in 2006. He took out his loan in francs because of the favorable interest rates, and for years, it seemed as if he got a better deal. But things turned around, and his monthly payments have increased more than $100 in the recent run-up.

"I can't sell the house now," said Mr. Wolany, a 30-year-old father of one who works in advertising. "The loan is bigger than the house is worth."

Last year, Hungary, facing a similar problem, forced banks to convert home loans denominated in francs to Hungarian forints at below-market rates. The country was criticized for the policy, which chilled the banking sector.

Poland, regarded as the model for Eastern European economic stewardship, had considered a similar path. The country's prime minister, Ewa Kopacz, said on Monday that she would side with the people over the banks.

By Wednesday, Polish officials rejected the Hungarian approach. Mateusz Szczurek, the finance minister, said, "It isn't the role of the government to be removing all possible risks people face."

Mateusz Zurawik contributed reporting.

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Borrowers in Hungary Learn Tough Lessons

By FLOYD NORRIS

For many people in Central and Eastern Europe, a new experience began a quarter-century ago. Communist governments collapsed, and the wide world of private ownership, democracy and free markets opened up suddenly.

It was not always a happy transition. This month, even as Germans were celebrating the anniversary of the fall of the Berlin Wall, the Hungarian government was passing laws and issuing edicts aimed at helping a large proportion of the populace recover from the mistake of buying houses with loans denominated in Swiss francs.

The story of how Hungarians wound up deeply in debt in Swiss francs — a currency many of them had never possessed and none of them earned at their jobs — is partly a story of European overconfidence during the boom that preceded the credit crisis. But it is also a story of how poor regulation of banks can be disastrous — at first for the customers and then for the banks.

The fascination with borrowing in foreign currencies spread through several countries in Central and Eastern Europe early in the current century. The benefits were obvious: Because interest rates in other currencies were much lower than those in local currencies, monthly payments on a mortgage denominated in euros or Swiss francs would be lower.

The risks were also clear: If the local currency fell relative to the foreign currency, monthly payments would rise, perhaps precipitously.

But at the time, that risk seemed manageable. Capital was flowing into the countries as they joined the European Union and began preparations to adopt the euro. Local currencies were strong and were expected to remain so.

Hungarians were perhaps the most eager to borrow in foreign currency, particularly after the government cut back on a previous program to subsidize mortgage loans made in the local currency, the forint.

"Starting in 2004, people forgot the government-backed mortgages," said Zoltan Torok, an economist for the Hungarian unit of Raiffeisen, an Austrian bank.

The government says half the households in the country ended up with foreign currency loans. And the situation was made worse by a lack of effective bank regulation. That enabled the banks to make a lot of money — until the disaster left them weak and the public furious.
Some of the loans were denominated in euros, which seemed to make sense at the time because it was widely — but wrongly — expected that Hungary would switch to the euro by 2009, five years after it joined the European Union. So someone who took out a 25-year mortgage in euros would have currency risk for only a few years.

But most of the loans were denominated in Swiss francs, simply because interest rates — and therefore initial monthly payments — were lower. When the Swiss franc appreciated relative to the euro after the financial crisis began in 2008, those borrowers were in even more trouble than those who borrowed in euros.

In nearby Poland, the government imposed some regulations. Foreign currency borrowers had to be better off than many borrowers and therefore better able to withstand the risk. The banks were limited in their discretion in choosing exchange rates and had to follow market interest rates in making adjustments — something that has helped tremendously. Polish borrowers have still suffered, but nothing like those in Hungary.

There, it turned out, only the banks were paying close attention to the details of the loan agreements people were signing. They gave the banks considerable discretion in determining the exchange rates they would follow and the interest rates that would be charged. The banks used that discretion to their own benefit.

From Debt to Disaster

In 2004 and 2005, many Hungarians borrowed foreign currencies, mostly Swiss francs, to buy homes. But from mid-2008 through 2009, the value of the Hungarian forint fell rapidly, raising home mortgage payments just as the country went into recession and unemployment soared.

Viktor Orban, the populist who has been Hungary’s prime minister since 2010, has tried a variety of measures to reduce the pain for the borrowers, including a moratorium on evictions of destitute homeowners and a scheme that reduced monthly payments but increased the amount owed. The government has imposed taxes on banks based on their assets, not their profits, of which there are not many.

The authoritarian tendencies of the Orban government have drawn criticism in other European capitals, but its promise to hold the banks accountable has not hurt its popularity at home.

In July, the government ordered the banks to pay compensation to borrowers who had been damaged by what the government viewed as unfair contracts. This week, Hungary’s constitutional court upheld that law, saying that fairness was always required, meaning the new law did not amount to retroactive legislation. The payments are expected to be made early in 2015.

“The amount the banks will have to pay back could be as much as 900 billion forints,” said Yves Lemay, the managing director of banking and sovereigns at Moody’s Investors Service in London, adding that amount, equal to about $3.5 billion, was “about 32 percent of the capital buffer of the entire system.”
The government announced this week terms of a conversion of outstanding foreign currency mortgage loans into forints. The banks were relieved that the government chose market rates and that it agreed to provide euros to banks, which had taken on euro obligations to hedge their risks on the mortgage loans.

But forcing conversion only assures there will not be more losses from future currency depreciation. It does nothing to offset the earlier depreciation. And the required compensation will not come close to making borrowers whole.

Susanne Urogdi Kocsis, a 57-year-old Budapest resident, says she borrowed the equivalent of 7.4 million forints, or around $42,000, in 2007 to buy a larger apartment for her family. She says she has already paid back 4.5 million forints, “but the bank is asking for 11 million.” She thinks converting the loan to forints, as the government is forcing banks to do, will be of little help. “A lot of people won’t be able to pay back, and we will never be able to get new loans,” she said this week.

Before the crisis, and the plunge in the forint, Hungary’s banking system appeared to be profitable and well capitalized. Now none of the banks have investment grade ratings. Moody’s, the credit rating firm, rates the only large Hungarian-owned bank, OTP Bank, at Ba2, the highest junk bond rating. Other banks, most of them controlled by Western European banks, have lower ratings. Several have needed capital infusions from corporate parents.

The forint is now worth about 36 percent less in Swiss francs than it was when Hungary joined the European Union in 2004. Hungary’s economy grew at an annual rate of 4.1 percent from 1999 to 2006. Seven years later, it was smaller than it had been in 2006, although it did grow 1.1 percent in 2013.

The banks have suffered huge losses, said Mr. Torok, the bank economist, mentioning both the economic slump and the government actions. “But it is not like somebody is winning. Everybody is losing. The households are losing. The government is not winning.”

Helene Bienvenu contributed reporting and Palko Karasz contributed research.