

# Monetary Appreciation and Foreign Currency Mortgages

## Lessons from the 2015 Swiss Franc Surge

**Abstract:** Since 2007 the Swiss franc had been getting stronger, but it was a decision by the Swiss National Bank to unpeg the Swiss franc from the Euro in 2015, which resulted in its significant appreciation and shocked FX markets. Many citizens in Central and Eastern Europe were directly affected because they had taken out mortgages denominated in Swiss francs or linked to Swiss francs. In these countries, foreign currency mortgages are common because the interest rates on foreign denominated loans are lower, foreign currencies are more stable than the local currency, some citizens earn their income abroad, etc. This article analyses the impact of the Swiss franc surge on mortgages denominated in or linked to Swiss francs from the perspective of contract law, consumer law and financial regulation. Then, it examines the strengths and weaknesses of the responses to the Swiss franc controversy of three jurisdictions — Bulgaria, Croatia and Serbia, which addressed the issue in distinct ways despite their relative legal cultural similarities. The purpose of the comparison is to consider what lessons may be learned from the Swiss franc surge and how they may inform the recent Directive 2014/17/EU on mortgage credit.

## 1. Introduction

1. On 15 January 2015, the Swiss National Bank (SNB) unpegged the Swiss franc from the Euro, which resulted in the significant appreciation of the Swiss franc.<sup>1</sup> Since 2007 the Swiss franc had been getting stronger,<sup>2</sup> but it was primarily this unexpected decision by the SNB which made thousands of citizens in Central and Eastern Europe (CEE) and beyond experience financial shock.<sup>3</sup> These citizens had taken out loans, including mortgages, denominated in Swiss francs or loans denominated in the local currency with a currency clause in Swiss francs.<sup>4</sup> Performance became costlier for borrowers — those who had taken out loans at a variable interest rate experienced a further burden.
2. Banks in the CEE region provided lower interest rates on loans in Swiss francs compared to loans denominated in the local currency, Euros or US dollars because they regarded the Swiss franc as a low-risk currency.<sup>5</sup> The attractive interest rate was not the only factor which informed the borrowers' choice of loan. Scholars argue that the 'long-term stable valuation of domestic currencies and their appreciation versus [the Swiss franc]' played a role in Poland and Hungary.<sup>6</sup> In some countries, personal circumstances were important. Serbia has a large diaspora in Switzerland — remittances in Swiss francs comprised 14% of the country's GDP between 2000 and 2011.<sup>7</sup> The recipients of remittances have an incentive to borrow in Swiss francs. Moreover, the lower interest rate on Swiss franc loans also meant that some borrowers met the creditworthiness criterion more easily. The low interest rate also implied that the same borrower could buy real estate of 'a larger size and higher value' compared to the one they could afford in the local currency.<sup>8</sup>
3. Following the Swiss franc surge, affected countries were confronted with a complex set of legal questions in the area of general contract law, consumer law and financial regulation, and

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<sup>1</sup> The peg was informal — the SNB had a policy to maintain the Swiss franc at a certain level; Analysts have observed that '[r]elative to its level in December 2014, the EUR/CHF appreciated by more than 20% on January 15, 2015, 14.0% three months later, 14.7% six months later, and 10.6% twelve months later', R. AUER, A. BURSTEIN & S.M. LEIN, 'Exchange Rates and Prices: Evidence from the 2015 Swiss Franc Appreciation', Bank for International Settlements, Working Paper 751, October 2018.

<sup>2</sup> See data on European Central Bank's site:

[https://www.ecb.europa.eu/stats/policy\\_and\\_exchange\\_rates/euro\\_reference\\_exchange\\_rates/html/eurofxref-graph-chf.en.html](https://www.ecb.europa.eu/stats/policy_and_exchange_rates/euro_reference_exchange_rates/html/eurofxref-graph-chf.en.html).

<sup>3</sup> In Croatia, more than 120,000 citizens were affected, E. MISCENIC, 'Croatian Case "Franak": Effective or "Defective" Protection of Consumer Rights?', *HJLSSSEE (Harmonius Journal of Legal and Social Studies in South East Europe)* 2016, p 186; In Serbia, more than 20,000 citizens were affected, A. OPACIC, V. PERISIC & J. GLUSCEVIC, 'The Problem of Currency-Indexed Loans — Case of "CHF"', 3-4. *IR (International Review)* 2016, p 143.

<sup>4</sup> In the latter case, the loan is given in the local currency but it is pegged to a foreign currency. Instalments are made in the local currency according to the exchange rate on the day the payment is due.

<sup>5</sup> See A. RANALDO and P. SODERLIND, 'Safe Haven Currencies', University of St Gallen, Discussion Paper no. 2007-22, May 2007.

<sup>6</sup> M. BUSZKO & D. KRUPA, 'Foreign Currency Loans in Poland and Hungary — A Comparative Analysis', 30. *PEF (Procedia Economics and Finance)* 2015, p 125.

<sup>7</sup> Swiss Agency for Development and Cooperation, *Swiss Cooperation Strategy Serbia: 2014-2017*, January 2014, [http://www.kingzollinger.ch/pdf/Final\\_CS\\_Serbia\\_2014-2017.pdf](http://www.kingzollinger.ch/pdf/Final_CS_Serbia_2014-2017.pdf).

<sup>8</sup> M. BUSZKO & D. KRUPA, 30. *PEF* 2015, p 125.

they had to tackle social unrest.<sup>9</sup> This article focuses on three jurisdictions — Bulgaria, Croatia and Serbia which relied on different mechanisms to respond to the Swiss franc controversy. Bulgaria’s *Комисия за защита на потребителите* (Commission for the Protection of Consumers) submitted a class action claim against three banks, but peculiarly reached three dissimilar results. Some consumers litigated individually under Directive 93/13/EEC on unfair terms.<sup>10</sup> In Croatia, the government imposed a blanket solution — in September 2015, the Croatian Parliament enacted amendments to the Credit Institutions Act and the Consumer Credit Act allowing the retroactive conversion of the affected loans from Swiss francs to Euros — a move which was criticized by the European Central Bank (ECB). Meanwhile, consumers sought collective redress under Dir. 93/13/EEC. After years of litigation, the Croatian court held that both the variable interest clause and the currency clause were unfair. In practice, this means that consumers can either seek the nullity of these clauses or the nullity of the entire contract in individual claims. In Serbia, *Народна банка Србије* (National Bank of Serbia) intervened with instructions for loan renegotiation while some courts allowed the application of the principle of change of circumstances. In 2019, nonetheless, after months of protests, *Врховни касациони суд* (Supreme Court of Cassation) handed down a binding legal opinion on how loans with currency clauses in Swiss francs should be handled. Subsequently, the Serbian Parliament enacted special legislation to enforce a comprehensive conversion solution.

The choice of jurisdictions is motivated by their diverse responses which illustrate the challenges which this unfortunate FX market development entailed. The fact that three jurisdictions responded differently is interesting because of the relative legal cultural similarities between them. All three are former-communist States. Bulgaria and Croatia are both European Union (EU) members.<sup>11</sup> Serbia was part of the same federation as Croatia (Yugoslavia) and is applying for EU membership.

This article examines the nature and complexity of the legal questions which arose in the Swiss franc controversy. After that, it studies the strengths and weaknesses of the Bulgarian, Croatian, and Serbian response. Then, it reflects upon how the lessons from the Swiss franc surge may inform the recent Directive 2014/17/EU on mortgage credit.<sup>12</sup> It should be noted that the latter is not directly relevant in this scenario because it entered into force after these loan agreements were concluded.

## 2. Setting the Scene: The Legal Questions

4. The main question in the circumstances is who should bear the risk of currency fluctuations in a loan agreement denominated in or pegged to a foreign currency and why. The factual

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<sup>9</sup> Scholars have analysed the social cost of Swiss franc loans for households. See P. RODIK, ‘The Impact of the Swiss Franc Loans Crisis on Croatian Households’, in S. Değirmencioğlu and C. Walker (eds), *Social and Psychological Dimensions of Personal Debt and the Debt Industry* (Houndmills: Palgrave Macmillan 2015), pp 61-83; In Serbia, Croatia, and Bulgaria, there were protests.

<sup>10</sup> Dir. 93/13/EEC of 5 April 1993 ‘on unfair terms in consumer contracts’, <http://data.europa.eu/eli/dir/1993/13/oj>.

<sup>11</sup> Bulgaria joined the EU in 2007 while Croatia — in 2013.

<sup>12</sup> Dir. 2014/17/EU of 4 February 2014 ‘on credit agreements for consumers relating to residential immovable property and amending Directives 2008/48/EC and 2013/36/EU and Regulation (EU) No 1093/2010’, <http://data.europa.eu/eli/dir/2014/17/oj>.

matrix should be examined from the perspective of contract law, including consumer law, and financial regulation:

### **2.1. The Contract Law Perspective**

5. From a general contract law perspective, one may first consider if these loans agreements were vitiated at the formation stage and if all conditions of validity of contract were fulfilled. Moreover, the fact that the Swiss franc surged post-entry into contract provides an opportunity to reason within the hypothesis of *rebus sic stantibus* (change of circumstances).<sup>13</sup>

Some Serbian scholars have contended that in the case of the Swiss franc surge, one can identify ‘intentional fraudulent behaviour of the management of the bank which as the dominant party of the adhesion contract was very aware of all risks of this loan taking, and on which it did not inform the client’.<sup>14</sup> Fraud and breach of the duties to inform are two separate but related issues. Fraud is a vitiating factor which rescinds an agreement and may give rise to damages under Serbian law.<sup>15</sup> In parallel, banks owe clients a duty of care — for example, in West European continental jurisdictions, courts have derived duties to inform based on the principle of good faith.<sup>16</sup> Article 12 of the Serbian Law of Obligations stipulates: ‘In establishing obligation relations and realizing rights and duties out of these relations, the parties shall adhere to the principles of good faith and honesty’. However, it may be difficult to prove the bank failed to inform the borrower of the risks and it is even more challenging to prove it breached information duties with the purpose to deceive. Notably, experts considered the Swiss franc as a safe haven currency.<sup>17</sup> The risk of palpable appreciation seemed remote at the time the loan agreements were concluded. Furthermore, some borrowers in Serbia earned their income in Swiss francs which constitutes a natural hedge for the loan from a financial standpoint.

The Roman concept of *causa* which has permeated European legal systems may also provide food for thought.<sup>18</sup> In some jurisdictions *causa* evolved as equivalence of obligations (prestations) at the formation stage — what the debtor receives should be equivalent to what

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<sup>13</sup> The origin of the *rebus sic stantibus* principle can be traced to the writings of philosophers like Seneca, Cicero, etc. It became a general principle of canon law in the 17<sup>th</sup> century. After falling into oblivion, it was revived in the aftermath of World War I in Germany and Austria, both of which suffered from monstrous inflation at the time. See R. ZIMMERMANN, *The Law of Obligations: Roman Foundations of the Civilian Tradition* (Cape Town: Juta 1990), pp 579-581; J. DAWSON, ‘Effects of Inflation on Private Contracts: Germany, 1914-1924’, 33. *MLR (Michigan Law Review)* 1934, pp 171-238.

<sup>14</sup> A. OPACIC, V. PERISIC & J. GLUSCEVIC, 3-4. *IR* 2016, p 140.

<sup>15</sup> For instance, Art. 65(1) of the Serbian Law on Obligations states: ‘Should one party mislead or continue to mislead the other party with the intention of inducing him into entering into contract, the other party may request rescission of the contract even if the mistake was not of a substantial nature’.

<sup>16</sup> D. BUSCH & C. VAN DAM, ‘A Bank’s Duty of Care: Perspectives from European and Comparative Law’, in D. Busch and C. Van Dam (eds), *A Bank’s Duty of Care* (Oxford: Hart Publishing 2017), Ch. 12, p 375.

<sup>17</sup> A. RANALDO and P. SODERLIND, University of St Gallen, Discussion Paper no. 2007-22, May 2007.

<sup>18</sup> In France, prior to the 2016 reform, *la cause* was one of the conditions of validity of contract. Although the legislator deleted the reference to the cause, scholars argue it has remained in spirit. See O. DESHAYES, T. GENICON & Y.M. LAITHIER, ‘La Cause a-t-elle réellement disparu du Droit français des Contrats?’, 13. *ERCL (European Review of Contract Law)* 2017, pp 418-430.

he gives to the creditor of the obligation.<sup>19</sup> Some countries have rules which allow courts to strike out concrete provisions because of contractual imbalances in non-consumer agreements.<sup>20</sup> While the concept of equivalence exists in Croatian, Serbian, and Bulgarian law, it is questionable if it can be of help in this scenario.<sup>21</sup> It seems difficult to argue that the mutual obligations of the parties were not equivalent at the time of formation. Debtors experienced difficulties only after the surge of the Swiss franc and they would not have experienced a substantial burden had the Swiss franc not become so strong.

It may be tempting to rely on the doctrine of equivalence regarding the validity of clauses allowing banks to alter the interest rates on loans unilaterally under certain conditions or regarding the currency clause. Writing extra-judicially, a Serbian judge has suggested that in times of drastic appreciation, the currency clause secures the bank the acquisition of a disproportionate material gain in relation to the debt of the borrower.<sup>22</sup> This argument does not seem convincing because it ignores the cost of the bank's funding.<sup>23</sup> To provide a loan in Swiss francs, banks which are not based in Switzerland need to find Swiss francs. It may be the case that they have Swiss francs on deposit — in this case, the price of funding is the interest on those deposits. Often, however, banks take a loan in Swiss francs from the interbank market. Other forms of financing include the currency swap and the interest rate swap. Just like the individual borrower must repay their loan with an interest to the bank, the bank must pay its own debt with an interest to the interbank market or the depositors.

6. The fact that borrowers experienced burdensome performance years after entry into contract provides an opportunity to consider the application of the principle of change of circumstances. In contemporary legal theory and practice, the concept is known under different names.<sup>24</sup> While the scope and criteria of application of this principle vary, many European jurisdictions have enshrined it in law.<sup>25</sup> Bulgaria, Serbia, and Croatia are no exception.<sup>26</sup>

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<sup>19</sup> For example, prior to the 2016 reform of the French law of obligations, former Article 1118 of the *Code civil* enshrined the notion of *lésion*. On the role of equivalence of obligations at the formation stage, see M. FABRE-MAGNAN, *Droit des obligations: 1-Contrat et engagement unilatéral* (Paris: PUF 2016), pp 444-464.

<sup>20</sup> See Article 1171 of the current French *Code civil*. For an overview, see O. DEASHAYES, T. GENICON & Y.M. LAITHIER, *Réforme du droit des contrats, du régime général et de la preuve des obligations: Commentaire article par article* (Paris: LexisNexis 2018), pp 340-355.

<sup>21</sup> See Article 15 of the Serbian Law on Obligations; Article 7 of the Croatian Obligations Act; Bulgaria's Law on Obligations and Contracts is more subtle — Bulgarian doctrine and practice derive the notion from the principles of fairness and good morals. See R. VASSILEVA, 'On the Diverging Conceptions of Fairness in English and Bulgarian Contract Law: The Peculiar Transformation(s) of Roman *Causa*', *OUCLF (Oxford University Comparative Law Forum)* 2019, <https://ouclf.iuscomp.org/on-the-diverging-conceptions-of-fairness-in-english-and-bulgarian-contract-law-the-peculiar-transformations-of-roman-causa/>.

<sup>22</sup> D. SLIJEPCEVIC, 'Application of the Currency Clause and a Variable Interest Rate in Bank Loan Contracts', *PZ (Pravni život)* 2016 (11.III), p 411.

<sup>23</sup> Financial experts have raised awareness that the mainstream debate ignores this vital question. See N. PANTELIC, 'The Nature of Borrowing in Foreign Currency', *PZ (Pravni život)* 2016 (11.III), p 444.

<sup>24</sup> Hardship (Article 6.2.2, UNIDROIT Principles), excessive onerosity (Article 1467, *Codice Civile*), exceptional change of circumstances (III.-1:110, Draft Common Frame of Reference), etc.

<sup>25</sup> Exceptions include Spain, Belgium, and England. See E. Hondius & H.C. Grigoleit (eds), *Unexpected Circumstances in European Contract Law* (Cambridge: Cambridge University Press 2014).

<sup>26</sup> See Arts 369 and subsequent from the Croatian Obligations Act, Arts 133 and subsequent of the current Serbian Law on Obligations, Article 307 of the Bulgarian Law on Commerce.

Some common criteria which emerge from comparative literature are unforeseeability, no fault requirement, onerous performance, etc.<sup>27</sup> Depending on context, their fulfillment may be questionable. Unforeseeability is a question of degree since, as a matter of principle, the currency market fluctuates. Regarding fault, one needs to examine if the effect of the supervening event on the agreement could have been prevented. For example, when performance became burdensome for borrowers, they could have converted the loan to a different currency against a fee. Regarding the onerousness of performance, various jurisdictions seem to put a different emphasis on the degree of change that is required. The new Article 1195 of the French *Code civil*, which enshrined the notion of *imprévision* in French law, requires that performance become ‘excessively onerous’.<sup>28</sup> In Bulgaria, nevertheless, Article 307 on economic onerosity in the Law on Commerce requires that performance be ‘contrary to fairness and good faith’. This seems to imply broader moral considerations. One may also question if the borrower is the only party experiencing burdensome performance considering the cost of banks’ funding. The drastic consequences which the principle of changed circumstances could have — terminate an agreement as we will see in the case of Serbia — may also deter courts from applying the doctrine.

7. One should remember that in the aftermath of World War I and II, some jurisdictions like France addressed the issue of *imprévision* in civil contracts by means of temporary legislation.<sup>29</sup> One may consider addressing the Swiss franc surge by enacting special statutes. However, at the time France relied on special legislation, circumstances were extreme. It has been calculated that French prices rose by 500% between 1914 and 1918.<sup>30</sup> This affected substantially the purchasing power of all citizens. In the case of the Swiss franc surge, nevertheless, the citizens who have taken out a loan in Swiss francs experience a different burden depending on their personal circumstances — the salary they earn, the currency in which they earn it, etc. Below, we will see two examples of special intervention. Croatia opted for special legislation allowing retroactive conversion of loans which caused a major controversy. In Serbia, the central bank issued a mandatory decision allowing loan renegotiation. Subsequently, Serbia’s Parliament also enacted special legislation permitting prospective conversion and loss apportionment.

## 2.2. *The Consumer Law Perspective: Dir. 93/13/EEC*

8. It seems important to consider if the fairness test under Dir. 93/13/EEC can be applied to the indexation clause and the currency clause. Dir. 93/13/EEC allows courts to set aside unfair terms. *A priori*, one of the weaknesses of relying solely on Dir. 93/13/EEC is that those borrowers who cannot be defined as ‘consumers’ under the Directive will not be able to find

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<sup>27</sup> See E. Hondius and H.C. Grigoleit (eds), *Unexpected Circumstances*.

<sup>28</sup> For a commentary on the new provision, see C. PEDAMON, ‘The Paradoxes of the Theory of *Imprévision* in the New French Law of Contract: A Judicial Deterrent?’, *ACJSALS (Amicus Curiae: Journal of the Society for Advanced Legal Studies)* 2017 (112), pp 10-17.

<sup>29</sup> See S. RENNER, *Inflation and the Enforcement of Contracts* (Cheltenham: Edward Elgar Publishing 1999), pp 15-17.

<sup>30</sup> H. OLIVER, ‘Economic Consequences of War since 1790: War and Inflation since 1790 in England, France, Germany, and the United States’, 30. *AER (The American Economic Review)* 1941, p 345.

relief.<sup>31</sup> Absent class action by local authorities for consumer protection, consumers will have to go to court individually and incur litigation costs — if they are already in a precarious position, they may struggle. In principle, the notion of class action is relatively new in EU Member States, so national laws are imperfect — below we will see that one claim was deemed unfounded in Bulgaria.

There may be difficulties in applying the fairness test, too. Article 3(1) of Dir. 93/13/EEC stipulates that ‘[a non-individually negotiated term] is unfair if, contrary to the requirement of good faith, it causes a significant imbalance in the parties’ rights and obligations arising under the contract, to the detriment of the consumer’. However, there is an important exception — the so-called core terms should not be subjected to fairness review unless they are not expressed in plain and intelligible language and they are not transparent.<sup>32</sup> 9. A series of preliminary references before the Court of Justice of the European Union (CJEU) show how challenging it is to apply Dir. 93/13/EEC to loan agreements.<sup>33</sup> Particularly interesting for our study is *Kàsler* which concerned a loan agreement denominated in a foreign currency. One of the questions the referring court asked was whether the mechanism for calculation of instalments stipulated in the contract was a core term under Dir. 93/13/EEC. The CJEU held that this term could be part of the subject-matter of the contract: it is for ‘the national court to ascertain having regard to the nature, general scheme and stipulations of the contract and its legal and factual context, that that term lays down an essential obligation of that agreement which, as such characterises it’.<sup>34</sup>

Depending on how they are drafted, indexation and currency clauses could be considered as part of the loan’s core terms, so they can be subjected to fairness review only if they are not expressed in plain language and they are not transparent. In *Kàsler* itself, the CJEU stressed that this was not just a matter of grammatical intelligibility: ‘...the consumer [should be] in a position to evaluate, on the basis of clear, intelligible criteria, the economic consequences for him which derive from [the term]’.<sup>35</sup> While helpful, this guidance may not preclude national judges from reaching different conclusions depending on their background. For example, if an indexation clause contains a reference to CHF LIBOR and no clarifications were made to the consumer about what this meant, it is unclear if national courts would consider this test satisfied although this is an internationally recognized benchmark interest rate.

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<sup>31</sup> Art. 2(b) defines ‘consumer’ as ‘any natural person who...is acting for purposes which are outside his trade, business or profession’.

<sup>32</sup> Core terms relate to the definition of the main subject matter of the contract or the adequacy of the price. See Art. 4(2) of Dir. 93/13/EEC.

<sup>33</sup> CJEU 20 April 2014, C-26/13, *Kàsler v. OTP Jelzálogbank*,

<http://curia.europa.eu/juris/document/document.jsf?text=&docid=151524&pageIndex=0&doclang=EN&mode=req&dir=&occ=first&part=1&cid=10571059>;

CJEU 26 February 2015, C-143/13 2015, *Matei v. SC Volksbank România*,

<http://curia.europa.eu/juris/document/document.jsf?text=&docid=162540&pageIndex=0&doclang=EN&mode=req&dir=&occ=first&part=1&cid=10571059>;

CJEU 20 September 2017, C-186/16, *Andricius v. Banca Românească*,

<http://curia.europa.eu/juris/document/document.jsf?text=&docid=194645&pageIndex=0&doclang=EN&mode=req&dir=&occ=first&part=1&cid=10571059>, etc.

<sup>34</sup> CJEU 20 April 2014, note 33 above, para. 59.

<sup>35</sup> *Ibid*, para. 75.

10. The fairness test itself may give rise to controversy in this scenario. Depending on how they find their funding, banks may also experience burdensome performance due to currency appreciation. It seems relevant to examine the model of funding of each bank to establish if there is a significant imbalance in the rights and obligations of lenders and borrowers. It is uncertain, however, if national judges have the necessary background to assess this. Below we will see that some of the arguments advanced by the Croatian courts when applying Dir. 93/13/EEC evidence biases towards banks.

### 2.3. *The Financial Regulation Perspective*

11. Considering how popular mortgages linked to Swiss francs were, one needs to examine the Swiss franc controversy from the perspective of financial regulation and macroeconomic policy. The concentration of foreign loans has worried the ECB for years. The European Systemic Risk Board has issued Recommendation ESRB/2011/1 of 21 September 2011 which specifically identifies areas which central banks are advised to monitor and measures they are recommended to take in case they recognize potential problems — Risk awareness of borrowers, Creditworthiness of borrowers, Credit growth induced by foreign currency lending, Internal risk management, Capital requirements, and Liquidity and funding.

What seems to be missing from the mainstream debate in literature is a more in-depth discussion about the efficiency of national central banks in identifying potential problems. Many critics are tempted to point fingers at the banks which underestimates the complexity of the issue.<sup>36</sup> In addition to developing preventive strategies, central banks are well placed to intervene and propose timely, comprehensive solutions in case of significant currency appreciation because they monitor foreign currency lending and exchange rates. In that light, it is striking that immediately after the 2015 Swiss franc surge, the central banks of Bulgaria, Croatia, and Serbia responded differently. *Българска народна банка* (the Bulgarian National Bank) has avoided public statements. *Hrvatska narodna banka* (the Croatian National Bank) issued a statement on 21 January 2015 in which it discussed various possible responses but concluded that the choice between such options was ‘primarily...political...due to the nature of such decisions’.<sup>37</sup> In stark contrast, as elaborated below, *Народна банка Србије* (the National Bank of Serbia) was proactive: it quickly issued a binding recommendation in February 2015 offering borrowers four options for loan renegotiation. While these diverse responses show different philosophies about central banking, it seems that the Serbian response was the most adequate because it provided timely relief to borrowers and attempted to strike a balance between their interests and the interests of lenders.

12. Finally, when seeking a solution to such a large-scale problem, one should also consider the impact it may have on the economy. If the risk is attributed entirely to the banks, they will suffer significant losses. This may affect their performance and have implications for third

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<sup>36</sup> A. OPACIC, V. PERISIC & J. GLUSCEVIC, 3-4. *IR* 2016, p 140; Linhardt who has interviewed bankers from different CEE countries which have been affected by the Swiss franc surge refers to an overt ‘anti-bank sentiment’ which is exploited by populist politicians, S. LINHARDT, ‘Walking Away: Anti-Bank Politics in Eastern Europe’ (*The Banker*, 1 August 2016), [https://www.thebanker.com/World/Central-Eastern-Europe/Bosnia-Herzegovina/Walking-away-anti-bank-politics-in-eastern-Europe/\(language\)/eng-GB](https://www.thebanker.com/World/Central-Eastern-Europe/Bosnia-Herzegovina/Walking-away-anti-bank-politics-in-eastern-Europe/(language)/eng-GB).

<sup>37</sup> ‘Some facts about loans in Swiss francs and some options for government intervention’, Press release of 21 January 2015, <http://old.hnb.hr/priopc/2015/eng/ep21012015.pdf>.



parties: banks may struggle to meet their obligations *vis-à-vis* depositors, they will be forced to limit access to loans of other companies and individuals, etc. As underlined below, according to the ECB, the Croatian blanket solution, which allowed retroactive loan conversion, imposed losses in the range of 1.1 billion Euros on the banks<sup>38</sup> which is significant considering the size of Croatia's economy.<sup>39</sup> Croatia ignored ECB's concerns that its intervention compromised macroeconomic stability and key legal principles such as legal certainty.

#### 4. Three Jurisdictions, Three Distinct Responses

13. It has been asserted that the diverse ways in which '...countries deal with the problem of currency risk in financing the real estate market prove that there is no single, universal method of action, and that it is not until later that we can assess the effectiveness of such actions'.<sup>40</sup> Now that we have set the scene and highlighted why there is no clear-cut answer to the Swiss franc controversy, we examine the responses in Bulgaria, Croatia, and Serbia:

##### 4.1. Bulgaria

14. The first reaction to the Swiss franc controversy from a public institution came from the *Комисия за защита на потребителите* (Commission for the Protection of Consumers, hereby referred to as the CPC) which issued a recommendation about unfair terms in Swiss franc loans in May 2015.<sup>41</sup> At the end of 2016, the CPC submitted a collective action claim against three banks which offered loan products linked to the Swiss franc in Bulgaria — a tardy response which resulted in three diverse outcomes. Unsurprisingly, many consumers sought relief individually under Dir. 93/13/EEC.

##### 4.1.1. Class Action: Three Diverse Outcomes

15. In May 2015, the CPC concluded that loan agreements in Swiss francs contained unfair terms because the currency risk was borne by the borrowers, borrowers understood how much they must pay only at the time of maturity, the methodology of calculating the interest rates was unclear, etc. It recommended that credit institutions modify these terms to restore the contractual balance in these agreements within 14 days.<sup>42</sup> One may argue that if these loan agreements had been incompatible with Dir. 93/13/EEC, the CPC should have reacted much earlier considering some of these loans were taken out in the mid-2000s. It is also interesting that despite the timeframe it proposed, the CPC submitted a collective action claim for alleged violations of Dir. 93/13/EEC against three banks, which offered products linked to Swiss franc, only at the end of 2016 — Eurobank, Unicredit and Piraeus.

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<sup>38</sup> ECB Opinion, CON/2015/32, 18 September 2015.

<sup>39</sup> Data from the World Bank shows Croatia's GDP was 49.49 billion US dollars in 2015, <https://data.worldbank.org/indicator/NY.GDP.MKTP.CD?locations=HR>.

<sup>40</sup> E. SIEMINSKA & M. KRAJEWSKA, 'Exchange Rate Risk on the Mortgage Market', 23. *REMV (Real Estate Management and Valuation)* 2015 (4), p 82.

<sup>41</sup> Protocol 22 of 27 May 2015; CPC Public Statement of 29 May 2015.

<sup>42</sup> *Ibid.*

This class action resulted in diverse outcomes which illustrates some of the risks of such proceedings. In principle, class action suits are a recent phenomenon in Bulgaria. They are governed by Chapter 39 of the Code of Civil Procedure. Scholars have criticized the procedural rules for lack of coherence and for imposing an unnecessary burden on the litigants.<sup>43</sup> A key issue which came into play *vis-à-vis* Piraeus was the requirement stipulated in Article 379(1) of the Code of Civil Procedure: ‘A collective action may be brought on behalf of persons injured by a violation where, according to the nature of the offence, their circle cannot be precisely defined but is determinable’. *Софийски градски съд* (Sofia City Court) found the claim unfounded because the number of injured parties was precisely defined.<sup>44</sup> This reasoning, however, may make collective action against banks difficult in the future because the number of loans and borrowers can always be counted.

By contrast, the CPC reached out-of-court settlements with the other two banks. It settled with Eurobank in November 2016.<sup>45</sup> The negotiations with Unicredit were tougher — the CPC reached an out-of-court settlement only in March 2018.<sup>46</sup> The prioritization of settlements over adversity evidences the more balanced approach by Bulgaria’s authorities which stands in stark contrast to the Croatian approach discussed below. The forward-looking terms of these settlements also show that a principle guiding the negotiations was risk apportionment.

The settlements with Eurobank and Unicredit are very similar in spirit. In both, the banks undertook to propose to their non-defaulting borrowers to convert the outstanding amount to be paid in Euros or Bulgarian levs. The banks also undertook to substitute the clauses providing for a variable interest rate based on their prior formulas with clauses providing for interest rates to be calculated based on SOFIBOR for loans in Bulgarian levs, EURIBOR for loans in Euros, and CHF LIBOR for loans which were not converted.<sup>47</sup> The main difference between the two settlements is that the one with Eurobank contains a specific formula for loss apportionment in the currency conversion between the borrower and the lender:

the amount formed shall be divided into two parts, the Bank being obliged to accept on its own account on the date of the conversion the part of the liabilities representing 20% of the Bulgarian lev equivalent of the debt, calculated based on the exchange rate on the date the loan was received.<sup>48</sup>

These solutions, however, have weaknesses. Borrowers who had already defaulted because of burdensome performance did not find relief. The mechanism for conversion agreed with Eurobank seems more favourable to consumers because it includes a form of loss apportionment in the conversion mechanism. As these solutions are forward-looking but

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<sup>43</sup> For an overview of the current debate, see Татьяна Маркова, „Колективните искиове: екс анте анализ на предявяването им в България“, Икономически и социални алтернативи, 2015 (1), стр. 142-52.

<sup>44</sup> Софийски градски съд, I-3 състав 28 June 2018, Решение по гр.д. №1304/2016 г. Bulgarian case law is best located on [www.apis.bg](http://www.apis.bg).

<sup>45</sup> Settlement of 18 November 2016.

<sup>46</sup> Settlement of 1 March 2018.

<sup>47</sup> SOFIBOR was the interbank exchange rate in Bulgaria until July 2018. EURIBOR is the European interbank exchange rate. CHF LIBOR is the average exchange rate at which London banks lend one another Swiss francs.

<sup>48</sup> Art. 2(2) of the Settlement of 18 November 2016; Author’s translation.

settlements were reached on different dates, Unicredit's clients were worse off because in the meantime they had to perform their obligations under the original loan agreements.

#### 4.1.2. Individual Claims: Inconsistent Application of Dir. 93/13/EEC

16. Considering CPC's tardy and inconsistent response and the difficulties in initiating class action claims, it is not surprising that consumers litigate individually. The future of many is uncertain because it may take a while before these disputes are conclusively resolved. As mentioned above, Dir. 93/13/EEC has given rise to a series of preliminary references before the CJEU concerning loan agreements which evidences the challenges of applying the Directive in this area. Bulgarian case law on Dir. 93/13/EEC is problematic because it raises doubts about how well judges understand the steps that should be taken when evaluating the fairness of a term. In turn, creative, non-autonomous interpretations challenge the uniform application of EU law.

As stated above, a key aspect of Dir. 93/13/EEC is establishing whether a given term is a core term. These terms can be subjected to fairness review only if they are not transparent and/or not expressed in plain and intelligible language. There are Bulgarian decisions concerning the fairness of loan agreements in which this step seems to have been omitted as judges ventured into discussing the fairness of the indexation clauses which were being challenged straight away.<sup>49</sup>

A second issue, which emerges from Bulgarian case law, is that courts do not seem to interpret the Directive autonomously. Autonomous interpretation is a key requirement of EU law. It 'means that the approach to interpreting domestic legislation implementing an EU Directive must reflect the European origins of the legislation by not relying on established national law, or the national laws of another Member State, in interpreting such a provision'.<sup>50</sup> The importance of autonomous interpretation has been emphasized by the CJEU, too.<sup>51</sup> However, when carrying out the fairness test, instead of relying on available CJEU case law at the time, which could be relevant, *Върховен касационен съд* (Bulgaria's Supreme Court of Cassation, hereby referred to as Bulgaria's SCC) cited definitions of good faith from Bulgarian doctrine.<sup>52</sup> In the same Decision, Bulgaria's SCC even held that the lower court concluded incorrectly that to examine the fairness of a term, one has to examine Article 145 of Bulgaria's Law on Consumer Protection which contains the core term exception.<sup>53</sup>

While in principle it has been contended that interpreting EU law based on the general principles of national law is not necessarily troublesome because it may result in Member State

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<sup>49</sup> Върховен касационен съд, I т. о. 2 December 2016, Решение №165 по т. д. №1777/2015 г.; Върховен касационен съд, I т. о. 7 November 2016, Решение №205 по т. д. №154/2016 г.

<sup>50</sup> C. TWIGG-FLESNER, *The Europeanisation of Contract Law: Current Controversies in Law* (Abingdon: Routledge, 2nd edn 2013), p 122.

<sup>51</sup> In CJEU 20 April 2014, note 33 above, at para. 37: 'According to settled case-law, the need of the uniform application of EU law and the principle of equality require that the terms of a provision of EU law which makes no express reference to the law of the Member States for the purpose of determining its meaning and scope must normally be given an autonomous and uniform interpretation throughout the European Union'.

<sup>52</sup> Върховен касационен съд, I т. о. 2 December 2016, Решение №165 по т. д. №1777/2015 г.

<sup>53</sup> *Ibid.*

friendly interpretation of EU law,<sup>54</sup> the Bulgarian approach raises a red flag. Coupled with the reluctance to follow the steps prescribed in Dir. 93/13/EEC and affirmed by the CJEU, relying on Bulgarian doctrine may challenge the more uniform application of EU law in the future.

Finally, there are cases in which consumers have already successfully challenged indexation clauses in Swiss franc loans — for instance, Decision 245 by the Plovdiv Appellate Court.<sup>55</sup> In light of the practice of Bulgaria’s SCC, lower courts do not seem to evaluate if the core term exception applies. From a comparative perspective, it is interesting that in Decision 245, the Bulgarian court was primarily concerned about the clarity of the indexation formula. It concluded that the bank could alter one of its components (credit risk) unilaterally which was unfair in its eyes. By contrast, as discussed below, in Croatia the debate was primarily anchored in information duties. Croatian courts deemed that the banks failed to explain adequately the risks associated with products linked to Swiss francs. There are also important differences in results. In Bulgaria, the court simply set the unfair term aside, which meant that the bank had to return to the borrower the interest rate they had overpaid because of the application of the indexation clause — the original interest rate was applicable throughout the lifecycle of the loan. In Croatia, it appears that borrowers may seek the nullity of the entire agreement.

## 4.2. Croatia

17. Compared to Bulgaria’s approach, Croatia’s approach prioritizes the interests of borrowers over the interests of lenders. Croatia implemented a radical blanket solution which allowed consumers to covert their loans in Swiss francs to Euros *retroactively* if they wished. Besides, 2018 saw the culmination of a 6-year class action suit against banks under Dir. 93/13/EEC: the Croatian court declared both the variable interest rate clause and the currency clause unfair.

### 4.2.1. The Blanket Solution: Retroactive Loan Conversion

18. In September 2015, Croatia enacted amendments to the Credit Institutions Act and the Consumer Credit Act allowing the conversion of loans in Swiss francs to loans in Euros as well as the conversion of loans denominated in Croatian kuna, which contain a currency clause linking payments to Swiss francs, into loans denominated in Croatian kuna with a currency clause linking payments to Euros.<sup>56</sup> The specificity of this solution lies in its retroactive, backward-looking nature, which differs from the Bulgarian approach — loans are treated as if they were taken out in Euros/had a currency clause in Euros from their inception. The amendments entered into force on 30 September 2015.

The main advantage of this solution is its comprehensive nature — unlike the Bulgarian piecemeal approach crafted by the CPC, Croatia’s authorities attempted to provide a solution which applied simultaneously to all banks. The Croatian approach, however, may be criticized

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<sup>54</sup> M. HESSELINK, ‘The General Principles of Civil Law: Their Nature, Roles and Legitimacy’, in D. Leczykiewicz & S. Weatherill (eds), *The Involvement of EU Law in Private Law Relationships* (Oxford: Hart Publishing 2013), pp 131-80.

<sup>55</sup> Пловдивски апелативен съд 10 August 2017, Решение №245 по в. т. д. №823/2016 г.

<sup>56</sup> For a discussion on the specifics of the amendments in English, see ECB Opinion CON/2015/32, 18 September 2015.

from a financial regulatory perspective because of its biases towards banks and the risks it imposed on the Croatian economy. The solution resulted into high-profile litigation before Croatia's Constitutional Court, and unleashed several claims against the country before the International Centre for the Settlement of Investment Disputes (ICSID) by foreign banks which argue breaches of investors' rights.<sup>57</sup> It appears that the plan to transfer the entire currency risk on the lenders may backfire since, in the event that the ICSID claims are successful, the damages will be paid by the Croatian taxpayers, most of whom are not stakeholders in the Swiss franc controversy.

19. It should be noted that the Croatian blanket solution worried the ECB too. Shortly after the Croatian government submitted the legislation for a vote in Parliament, the ECB issued a critical Opinion on this legislative initiative pursuant to Article 127(4) and Article 282(5) of the Treaty on the Functioning of the European Union, which pertain to monetary policy and the powers of the ECB.<sup>58</sup> The ECB raised concern about the likely effects on Croatia's economy, such as the decline in international reserves and compromising macroeconomic stability, the retroactivity of the law which jeopardizes legal certainty and the principle of legitimate expectations, the fact that the solution has not been assessed for compliance with Croatian law as well as its effects on the banking sector.<sup>59</sup> Croatia attributed losses of more than 1.1 billion Euros onto the banks.<sup>60</sup> Moreover, while the Opinion is phrased in a diplomatic way, one may sense a degree of disapproval of the policies of Croatia's central bank. The ECB stressed that it had raised awareness of currency risks in the past and it had issued a Recommendation how to tackle them.<sup>61</sup> Meanwhile, in 2015, 70% of the loan portfolio of Croatian banks was 'in or linked to foreign currencies'.<sup>62</sup>

20. The subsequent litigation before Croatia's *Ustavni sud* (Constitutional Court) initiated by lenders and private individuals contesting the constitutionality of the amendments may provide insights into Croatia's legal culture. With two Decisions of 4 April 2017, the Constitutional Court declared the request for constitutional review of the conversion laws to be inadmissible.<sup>63</sup> While a constitutional analysis is beyond the scope of this article, it is worth mentioning some particularities which stand out in Decision U-I-3685/2015 et al.

One of the key factors on which the Constitutional Court relied was the protection of social justice which is 'the highest value of the constitutional order of the Republic of Croatia and the basis for the interpretation of the Constitution'.<sup>64</sup> Article 1 of Croatia's Constitution defines the country as a 'democratic welfare State' and Article 3 specifically mentions *socijalna*

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<sup>57</sup> *Erste Bank v. Croatia* (ICSID Case No. ARB/17/49), *Addiko Bank v. Croatia* (ICSID Case No. ARB/17/37), *Raiffeisen Bank v. Croatia* (ICSID Case No. ARB/17/34), *Unicredit Bank v. Croatia* (ICSID Case No. ARB/16/31); The cases are pending and the materials are not currently public.

<sup>58</sup> CON/2015/32, 18 September 2015.

<sup>59</sup> *Ibid*, pp 4-5.

<sup>60</sup> *Ibid*, p 5.

<sup>61</sup> Recommendation ESRB/2011/1 of 21 September 2011.

<sup>62</sup> CON/2015/32, 18 September 2015, p 5.

<sup>63</sup> *Ustavni sud* 4 April 2017, U-I-3685/2015 et al.,

[https://narodne-novine.nn.hr/clanci/sluzbeni/2017\\_04\\_39\\_873.html](https://narodne-novine.nn.hr/clanci/sluzbeni/2017_04_39_873.html);

*Ustavni sud* 4 April 2017, U-I-4455/2015,

[https://sljeme.usud.hr/Usud/Praksaw.nsf/C12570D30061CE54C12580F9002C9D33/\\$FILE/U-I-4455-2015.pdf](https://sljeme.usud.hr/Usud/Praksaw.nsf/C12570D30061CE54C12580F9002C9D33/$FILE/U-I-4455-2015.pdf).

<sup>64</sup> U-I-3685/2015 et al, note 63 above, para. 26.3.

*pravda* (social justice) as one of the utmost values of the Croatian State. The majority concluded that the State

...had a positive obligation to take certain measures in the economy or to engage in market function to ensure the attainment of fundamental social rights and social security and to equalize or reduce the extreme social differences resulting from the appreciation of the Swiss franc.<sup>65</sup>

This argument illustrates an important difference between Croatia, on the one hand, and Bulgaria and Serbia, on the other: in the latter two jurisdictions the debate was anchored primarily in contract and consumer law.

A second aspect, which is interesting, is that when discussing the proportionality of the measures taken by the government, the majority directly confronted ECB's Opinion. It was held that the Opinion neither 'took into account the numerous benefits (both direct and indirect) of both credit institutions and the society as a whole' nor 'the opportunity costs that the credit institutions...would have had if there had been no conversion'.<sup>66</sup> From a financial perspective, this argument is not convincing because it imposes on the banks the atypical responsibility to consider the social good. It has been contended that banks do not run on empathy but on financial logic.<sup>67</sup> The court's subsequent argument that because of currency clauses, 'credit institutions have undoubtedly made significant gains due to the obvious violation of the principle of equivalence of performance and the equality of the contracting parties' shows lack of appreciation of how banks find their funding.<sup>68</sup> As explained above, to provide these loans, banks had probably undertaken obligations towards the interbank market, so the argument that they 'undoubtedly made significant gains' seems to be grounded on assumption.

A third particularity of the decision is its discussion on retroactivity. The majority argued that EU law distinguished between true and quasi retroactive effect in which the new rule applies to relationships created by legal acts which were made before its entry into force but were not completed.<sup>69</sup> It asserted that the latter one was permissible under the condition that the aim pursued was legitimate. The majority is walking on thin glass here and it is not surprising that there was a dissenting opinion on this point. One of the rare decisions in which such quasi retroactivity was recognized is *Amylum v. Council* which concerns the imposition of quotas on a specific type of sugar.<sup>70</sup> The European Court of Justice (ECJ) was concerned about unforeseeability — it held that the Council 'had clearly manifested an intention of regulating the production of all sweeteners'.<sup>71</sup> In the case of the conversion law, it is difficult to argue that when the banks gave out the loans, it was foreseeable that years later Croatia would pass a conversion law.

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<sup>65</sup> Ibid, para. 26.8; Author's translation.

<sup>66</sup> Ibid, para. 30.4; Author's translation.

<sup>67</sup> N. PANTELIC, *PZ* 2016 (11.III), p 444.

<sup>68</sup> Ustavni sud 4 April 2017, note 63 above, para. 29.2; Author's translation.

<sup>69</sup> Ibid, para. 34.2.

<sup>70</sup> ECJ 30 September 1982, Case 108/81, *Amylum v. Council*,

<http://curia.europa.eu/juris/showPdf.jsf?text=&docid=91411&pageIndex=0&doclang=EN&mode=req&dir=&cc=first&part=1&cid=10578554>.

<sup>71</sup> Ibid, para. 14.

Overall, the formal clash between Croatia's constitutional order and the ECB as well as the questionable application of EU law pertinent to retroactivity seem to indicate that this is a political decision. In turn, in case the ICSID claims are successful, the burden will be transferred to innocent third parties which does not seem compatible with the idea of social justice.

#### 4.2.2. Class Action under Dir. 93/13/EEC: Loans for Free?

21. In 2018, lenders in Croatia received a second blow with the outcome of the so-called *Franak* litigation. *Franak* is a consumer association whose name means 'Swiss franc' in Croatian.<sup>72</sup> Its initial goal was to defend the rights of borrowers who experienced burdensome performance due to the Swiss franc surge. In 2012, it was backed by *Potrošač – Društvo za zaštitu potrošača Hrvatske* (Consumer – Croatian Union of the Consumer Protection Associations) to submit a class action suit against eight banks arguing that variable interest rates and currency clauses constituted unfair terms under Dir. 93/13/EEC. How the *Franak* litigation unraveled illustrates not only the difficulties of applying Dir. 93/13/EEC as argued by scholars, but also the specific values of Croatia's legal culture.<sup>73</sup>

In a Decision of 4 July 2013, *Trgovački sud u Zagrebu* (Zagreb's Commercial Court) declared both the variable interest clause and the currency clause unfair under Dir. 93/13/EEC because of the lenders' failure to inform consumers of the factors affecting interest rates in the former case and to inform them of the risks in the latter case.<sup>74</sup> On appeal, *Visoki trgovački sud Republike Hrvatske* (High Commercial Court of Croatia) quashed the decision in part and held that the currency clause was part of the core terms of the loan agreement and could not be subjected to the fairness test.<sup>75</sup> *Vrhovni sud Republike Hrvatske* (Croatia's Supreme Court) affirmed the approach of the High Commercial Court in 2015.<sup>76</sup> In 2016, nevertheless, *Ustavni sud* (Croatia's Constitutional Court) found the latter decision ill-founded.<sup>77</sup> In the eyes of the Constitutional Court, the Supreme Court not only had not clearly explained the criteria it used to conclude that the currency clause could not be subjected to the fairness test, but also it did not properly state why *Käsler* was irrelevant in assessing the fairness of the currency clause.<sup>78</sup> Subsequently, the Supreme Court ordered new proceedings.<sup>79</sup> In 2018, the High Commercial Court of Croatia affirmed the conclusions in the initial decision of Zagreb's Commercial Court of 4 July 2013 regarding the unfairness of the currency clause.<sup>80</sup>

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<sup>72</sup> <http://udruzafranak.hr/>.

<sup>73</sup> E. MISCENIC, *HJLSSSEE* 2016, pp 184-209.

<sup>74</sup> *Trgovački sud u Zagrebu* 4 July 2013, P-1401/12.

<sup>75</sup> *Visoki trgovački sud* 13 June 2014, Pž-7129/13-4, [http://www.vtsrh.hr/uploads/Novosti/VTSRH\\_P%C5%BE\\_7129-13-4\\_AN.pdf](http://www.vtsrh.hr/uploads/Novosti/VTSRH_P%C5%BE_7129-13-4_AN.pdf), p 2.

<sup>76</sup> *Vrhovni sud* 9 April 2015, Revt-249/14-2, <http://www.vsrh.hr/CustomPages/Static/HRV/Files/Priopcenje-2015-05-14.pdf>.

<sup>77</sup> *Ustavni sud* 3 December 2016, U-III – 2521/2015 et al, [https://sljeme.usud.hr/Usud/Praksaw.nsf/C12570D30061CE54C125808E0037B96C/\\$FILE/U-III-2521-2015%20i%20dr.pdf](https://sljeme.usud.hr/Usud/Praksaw.nsf/C12570D30061CE54C125808E0037B96C/$FILE/U-III-2521-2015%20i%20dr.pdf).

<sup>78</sup> *Ibid*, paras. 19-20; CJEU 30 April 2014, note 33 above.

<sup>79</sup> *Vrhovni sud* 3 October 2017, Revt 575/16-5, <http://www.vsrh.hr/CustomPages/Static/HRV/Files/2017dok/VSRH-Priopcenje-Revt-575-2016-5-an.pdf>.

<sup>80</sup> *Visoki trgovački sud* 14 June 2018, Pž-6632/2017-10,

22. The ultimate result of the *Franak* litigation under Croatian law is that borrowers can either seek the nullity of the entire agreement or the nullity of the variable interest clause and the currency clause in individual claims which invoke the latest High Commercial Court decision.<sup>81</sup> If courts recognize the nullity of the entire agreement, this may mean that loans are for free in practice — consumers will owe banks only the principal they received as calculated in Croatian kunas on the day the loan was taken while banks will have to return to consumers all interest they have received. Alternatively, recognizing only the nullity of the variable interest rate clause and the currency clause will mean that banks must return what consumers have overpaid as a result of the application of these provisions. Recent case law suggests that those borrowers who have already taken advantage of the blanket conversion solution may also rely on the latest High Commercial Court decision.<sup>82</sup> It remains to be seen how these claims unravel — at this stage it seems that most consumers will ask for damages based on the nullity of the unfair clauses since seeking the nullity of the entire agreement is the more difficult path.<sup>83</sup>

23. One quickly notes several key differences between the Bulgarian case of class action and the *Franak* litigation. Croatian consumers did not seek an amicable solution. The outcome attributed to the banks further significant losses in addition to the blanket solution. Moreover, although it is difficult to analyse the legal reasoning of the Croatian decisions in details considering their substantial volume, it seems that Croatian courts have a more pronounced paternal approach towards consumers compared to Bulgarian courts.<sup>84</sup> This is particularly visible in the decision by Zagreb's Commercial Court.

24. Whereas Zagreb's Commercial Court held that the disputed clauses were unfair because the lenders failed to properly inform the borrowers of the consequences of loans denominated in Swiss francs with an indexation clause and loans with a currency clause in Swiss francs,<sup>85</sup> some of the court's reasons in reaching these conclusions are revealing of the values of Croatia's legal culture. For example, one of the main reasons why the court concluded that the appreciation of the Swiss franc was foreseeable for the banks as early as 1997 was a paper published on the website of the International Monetary Fund (IMF), which discussed the

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[http://www.vtsrh.hr/uploads/Novosti/VTSRH\\_P%C5%BE-6632-2017-10.pdf](http://www.vtsrh.hr/uploads/Novosti/VTSRH_P%C5%BE-6632-2017-10.pdf).

<sup>81</sup> The price is an essential term of any contract. In turn, the price in a loan agreement is the interest rate. If both the indexation clause and the currency clause are unfair, one may argue the price is unclear and thus challenge the entire agreement.

<sup>82</sup> CJEU 14 March 2019, C-118/17, *Dunai v. ERSTE Bank Hungary*,

<http://curia.europa.eu/juris/document/document.jsf?text=&docid=211709&pageIndex=0&doclang=EN&mode=lst&dir=&occ=first&part=1&cid=10581954> concerns a Hungarian case in which one of the questions asked by the referring court was whether legislation on conversion of loans precluded the application of Dir. 93/13/EEC. The CJEU concluded at para. 56 that Art. 6(1) of Dir. 93/13/EEC 'precludes national legislation which prevents, in circumstances such as those at issue in the main proceedings, the court seised of the case from granting an application for the cancellation of a loan contract on the basis of the unfair nature of a term relating to exchange rate risk where it is found that that term is unfair and that the contract cannot continue to exist without that term'; In February 2019, *Vrhovni sud* concluded that borrowers who converted their loans had a legal interest in seeking the nullity of clauses in the original agreement. See *Vrhovni sud* 12 February 2019, Rev-2868/2018-2, [http://www.vsrh.hr/custompages/static/HRV/files/2019dok/Priopcenja/VSRH\\_Rev\\_2868-2018-2.pdf](http://www.vsrh.hr/custompages/static/HRV/files/2019dok/Priopcenja/VSRH_Rev_2868-2018-2.pdf).

<sup>83</sup> This is the approach currently advocated by *Franak*.

<sup>84</sup> For instance, the Decision by Zagreb's Commercial Court is 180 pages long. The Decision by the Constitutional Court is 77 pages long.

<sup>85</sup> *Trgovački sud u Zagrebu* 4 July 2013, P-1401/12, p 1.



possible effects of the European Monetary Union on Switzerland and in which the appreciation of the Swiss francs was one of the scenarios examined.<sup>86</sup> The existence of this paper, in the eyes of the court, proved that the banks as well as their parent banks abroad knew about the existence of such forecasts, but did nothing to inform their consumers of this possibility.<sup>87</sup>

However, the paper itself has an official disclaimer that it presents the views of the authors, not the IMF.<sup>88</sup> A key aspect here is that forecasts are always speculative because they are based on simulations. The authors themselves have indicated that ‘all simulations represent deviations from the baseline forecast in the IMF’s World Economic Outlook 1996’.<sup>89</sup> One may also wonder how the existence of one paper imposes on the banks a responsibility to acquaint their customers with its findings, all the more that the purpose of the paper’s authors was to suggest what the SNB could do to avoid these developments. In parallel, if indeed we accept that this scenario was well known to the banks, it also means it was well known to Croatia’s central bank, which did not take adequate measures to curtail the accumulation of loans denominated in Swiss francs.

A second striking argument in this decision is the court’s claim that the bank’s reference to the fluctuations of the CFH LIBOR as a reason to modify the interest rates on loan agreements was ‘erroneous’ because the Swiss franc was only an ‘abstract value’ for accounting purposes as the banks did not have to buy Swiss francs to provide the loans.<sup>90</sup> Such claims do not show much sympathy towards how banks find their funding — in the case of agreements with a currency clause, the amount was written in Croatian kuna for the borrower’s convenience, but it does not necessarily mean the bank found the funding in Croatian kunas. Below we will see that in Serbia, the courts explicitly asked the banks to provide proof about how they funded these loans.

### 4.3. *Serbia*

25. Unlike Bulgaria’s central bank, which assumed the role of a bystander, or Croatia’s central bank, which transferred the hot potato to the government, *Народна банка Србије* (the National Bank of Serbia) was proactive. Shortly after the 2015 surge, on 24 February 2015, it issued a Decision with which it obliged banks to propose their borrowers four options.<sup>91</sup> Two of them included the opportunity to convert the loans from Swiss francs to Euros with a favourable exchange rate and to request extension of the repayment term. Two of them allowed borrowers to keep the loans in Swiss francs but under better conditions — a lower interest rate, an extended term for repayment, etc. Similarly to Bulgaria’s case, this approach is forward-looking and represents an attempt to seek a compromise solution in the form of risk apportionment. The Serbian approach seems better than the Bulgarian one because it is

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<sup>86</sup> Ibid, pp 138-140.

<sup>87</sup> Ibid, p 140.

<sup>88</sup> D. LAXTON & E. PRASAD, ‘Possible Effects of European Monetary Union on Switzerland: A Case Study of Policy Dilemmas Caused by Low Inflation and the Nominal Interest Rate Floor’, IMF Working Paper No. 97/23, p 1.

<sup>89</sup> Ibid, p 20.

<sup>90</sup> P-1401/12, p 153.

<sup>91</sup> Odluka o merama za očuvanje stabilnosti finansijskog sistema u vezi s kreditima indeksiranim u stranoj valuti, [https://www.nbs.rs/internet/latinica/20/zast/finansijska\\_stabilnost\\_krediti.pdf](https://www.nbs.rs/internet/latinica/20/zast/finansijska_stabilnost_krediti.pdf).

timely. Nevertheless, very few borrowers took advantage of these offers and many litigated before the courts. One may suspect that the news of the Croatian radical approach made borrowers question why Serbia did not endorse a similar solution.

#### 4.3.1. *Changed Circumstances and Duties to Inform*

26. Some borrowers challenged their loan agreements by relying on general contract law. However, Serbian court practice seems inconsistent. Particularly interesting is a decision by *Апелациони суд у Новом Саду* (the Appellate Court of Novi Sad) from September 2016 in which relief was granted based on the principle of changed circumstances which is governed by Article 133 and subsequent of the current Serbian Law on Obligations.<sup>92</sup> The case concerned a long-term mortgage agreement (270 months) with a currency clause in Swiss francs which was concluded in 2006. The court held that this was ‘undoubtedly’ a case of changed circumstances because of the substantial appreciation of the Swiss franc, the difficulty of performing the obligations in the agreement, and the fact that the contract no longer corresponded to the parties’ expectations.<sup>93</sup> A key factor in the decision was that from 2006 when the agreement was concluded until 2016, the official middle exchange rate of the Swiss franc against the Serbian dinar appreciated by 129% while the exchange rate against the Euro appreciated by 57%.

This decision attracted polarized commentaries. Writing-extrajudicially, a constitutional judge commended the judgment and emphasized that when the contract was entered into, objectively nobody could foresee or prevent this appreciation.<sup>94</sup> This argument, however, appears superficial since the effects of the appreciation could have been curtailed. As it appears from the decision, the contract itself provided that the borrower could convert the mortgage into Euros against a fee. It has also been contended that by itself the appreciation of the Swiss franc did not make performance more burdensome — those who earned their income in Swiss francs were not affected in any way.<sup>95</sup> Furthermore, the decision ignores the fact that the cost of the bank’s funding may also have increased.

The outcome in the above decision can also be criticized because of its retroactive effect. It has been asserted that in this particular case, one has to ‘return what has been given together with all legally prescribed default interest calculated from the date of the received principal...’<sup>96</sup> The borrower has to return the principal they received in Serbian dinars on the date the agreement was concluded while the bank has to return to the borrower all payments they made. This result attributes a significant loss to the bank. Besides, the borrower may still

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<sup>92</sup> Апелациони суд у Новом Саду 1 September 2016, Гж 1781/2016. The decision is available on <https://sudskapraksa.sud.rs>; Note Serbia is planning to enact a new civil code. For an overview of the reform, M. DJUROVIC, ‘Serbian Contract Law: Its Development and the New Serbian Civil Code’, 1. *ERCL (European Review of Contract Law)* 2011, pp 65-77.

<sup>93</sup> The main criteria of application of the principle are defined in Article 133 of the Serbian Law on Obligations: 1) supervening circumstances which hinder performance; 2) the contract no longer meets the expectations of the parties; 3) it is unjust to maintain the contract as it is; 4) unforeseeable event.

<sup>94</sup> D. SLIJEPCEVIC, *PZ* 2016 (11.III), p 414.

<sup>95</sup> P. CATIC, ‘Currency Clause, Termination and Consequences of Termination of the Loan Agreement with a Currency Clause’, *PZ (Pravni život)* 2016 (11.III), p 436.

<sup>96</sup> D. SLIJEPCEVIC, *PZ* 2016 (11.III), p 421.

lose their flat if they fail to return the principal they received. Moreover, this solution compromises legal certainty and may impact the banking sector negatively if adopted on a large scale.

In 2018, Serbia's *Врховни касациони суд* (Supreme Court of Cassation, hereby referred to as Serbia's SCC) quashed this decision and returned the case to the first instance court for retrial.<sup>97</sup> The main reason was that the lower instances did not examine if the borrower took advantage of the contractual clause allowing loan conversion. Moreover, it did not determine if the bank offered loan conversion, as recommended by the Serbian central bank. Serbia's SCC asked the lower instance to examine if the borrower could have avoided the change of circumstances. The most interesting aspect of this Decision, however, is that Serbia's SCC encouraged the lower court to examine if the borrower correctly understood the contract's contents and could assess the economic consequences, including the foreign exchange risk, in light of the obligation of honesty under general contract law as well as the Serbian Law on Consumer Protection.

27. This decision by Serbia's SCC seems to be part of a trend to remind lower courts of their obligation to consider consumer law while, at the same time, keep the door open for the application of the principle of changed circumstances. In 2017, for instance, Serbia's SCC quashed in part a decision by the lower instances regarding a case concerning similar facts and sent it for retrial by the first instance court. One difference between this case and the one discussed above is that in addition to arguing change of circumstances, the borrower sought the nullity of a currency clause and a variable interest clause.<sup>98</sup> Serbia's SCC concluded that the lower courts had correctly determined that these clauses were valid because they complied with good morals and public order. However, Serbia's SCC deemed that the lower courts had rejected the borrower's claim for changed circumstances without examining all criteria of application. Serbia's SCC emphasized that it was imperative for the first instance to establish if the Swiss franc surge was foreseeable for the bank and if the lender complied with their obligation of honesty under Article 12 of the Law on Obligations as well as their obligations under the Serbian Law on Consumer Protection by informing the borrower of the likely negative consequences. Furthermore, it is interesting that it asked the lower court to determine how and under what conditions, including exchange rates, the lender found the funding for this loan. The latter clearly indicates that Serbia's SCC is more sensitive to the specifics of the banking industry compared to Croatian courts.

#### 4.3.2. *An (Un)usual Court Intervention*

28. Under Serbian law, Serbia's SCC may render binding legal opinions when legal practice is divided.<sup>99</sup> After months of protests calling for a court intervention which could put an end to

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<sup>97</sup> Врховни касациони суд 21 June 2018, Rev 2373/2016, <https://www.vk.sud.rs/sr-lat/rev-23732016-obligaciono-pravo-ugovor-o-kreditu-raskidanje-ili-izmene-ugovora-zbog-promenjenih>.

<sup>98</sup> Врховни касациони суд 27 April 2017, Prev 60/2016, <https://www.vk.sud.rs/sr-lat/prev-602016-ugovor-o-kreditu-ni%C5%A1tavnost-odredbi-o-ugovorenoj-kamatnoj-stopi-raskid-ugovora-zbog>; In the Decision of 21 June 2018, Serbia's SCC says that it is possible that the claimants made such an ancillary submission, but the lower courts focused on their main submission that this was a case of changed circumstances.

<sup>99</sup> See Art. 43 of the Law on the Organization of the Courts; These opinions are binding on Serbia's SCC. If lower courts do not abide by them, their decisions may be challenged before Serbia's SCC.

the uncertainty faced by borrowers litigating against the banks, on 2 April 2019, Serbia's SCC rendered a *pravno shvatanje* (legal opinion) on the currency clauses in Swiss franc loans.<sup>100</sup> From a Western perspective, this legal opinion is interesting because of its length (it consists of five paragraphs only) and its declarative tone. It reads like an instruction rather than an opinion because Serbia's SCC does not specify the legal grounds on which it reached these conclusions.

It is visible that the court aimed at striking a balance between the interests of both lenders and borrowers which stands in stark contrast to the Croatian approach discussed above. As underscored in paragraph 1 and 2 of the legal opinion, the currency clause is not *a priori* null and void. It should be established how the banks found the funding for these loans and if they informed the borrowers of the economic consequences of this clause. Paragraph 3 of the legal opinion stresses that the invalidity of the currency clause does not void the entire agreement. The legal consequence prescribed by Serbia's SCC is the retroactive conversion of the loan to Euros based on the exchange rate between the Serbian dinar and the Euro on the day the contract was concluded. The applicable interest rate would be the same as the one in loans of the same type and duration concluded with a currency clause in Euros. The rest of the opinion advises that proceedings for specific performance initiated by the banks be stayed before the litigation concerning a loan is completed. In other words, unlike Croatia which allowed both retroactive conversion and damages for breaches of Dir. 93/13/EEC, Serbia's SCC prescribed conversion as a remedy for the invalidity of the currency clause.

29. At the time of writing of this article, it seems uncertain how the Swiss franc controversy will be conclusively resolved in Serbia. On 25 April 2019, the Serbian Parliament enacted special legislation prescribing specific rules for conversion of mortgages indexed in Swiss francs to further ease social tension — *Закон о конверзији стамбених кредита индексираних у швајцарским францима*. Pursuant to Article 4 of the new law, banks should offer borrowers to convert the outstanding amount to Euros — once converted, the amount is reduced by 38%. The same provision obliges banks to propose to borrowers the interest rate they offered on loans denominated in Euros on 31 March 2019. It also puts caps on variable and fixed interest rates. Essentially, this solution is very close in spirit to the settlement reached between Bulgaria's CPC and Eurobank because it is prospective and aims at loss apportionment. Article 9 of the aforementioned law also specifies that the borrowers who do not take advantage of this solution would repay the loans according to the terms of their original agreement, which, in practice, means that if they choose to litigate, the legal opinion of Serbia's SCC would be applicable.

## 5. Lessons

30. Three jurisdictions responded to the Swiss franc controversy in distinct ways which evidences the complexity of the challenge with which they were confronted. They struggled to find the balance between the interests of borrowers and lenders. Furthermore, the inconsistent and untimely application of the principles of contract and consumer law seems to indicate that institutions and courts had to overstretch their limits.

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<sup>100</sup> Full text available here:

<https://www.vk.sud.rs/sites/default/files/attachments/Pravno%20shvatanje%20CHF.pdf>.

This section considers how the bitter experience in Bulgaria, Croatia, and Serbia may inform the recent Dir. 2014/17/EU. It has been argued that while Dir. 2014/17/EU is an improvement, it ‘fails to solve all questions and create a leading novel model in the world’.<sup>101</sup> One can draw a similar conclusion based on our discussion above.

### **5.1. Information Duties**

31. Dir. 2014/17/EU provides more clarity about the specific information that should be supplied to consumers. Articles 13 and 14 of Dir. 2014/17/EU provide guidance about general information duties and pre-contractual information duties. Chapter 9 of the Directive pertaining to ‘foreign currency loans and variable rate loans’ stipulates rules about the information that should be supplied to consumers about variable rate loans. Namely, Article 24(a) requires that index rates be ‘clear, accessible, objective and verifiable’. Article 24(b) obliges lenders to maintain historical records of such indexes. Recital 4 of the Directive states the rationale for tackling these issues:

A series of problems have been identified in mortgage markets within the Union relating to irresponsible lending and borrowing and the potential scope for irresponsible behaviour by market participants...Some problems concerned credits denominated in a foreign currency which consumers had taken out in that currency in order to take advantage of the borrowing rate offered but without having adequate information about or understanding of the exchange rate risk involved.

32. It has been stressed, however, that ‘[it] is unclear whether the principles like ex-ante information...will constitute a safety net when the next crisis arrives’.<sup>102</sup> It is realistic to expect that banks will be very cautious when informing their clients to curtail the possibility of costly litigation and losses. The same conclusion can be drawn from the outcome of the *Franak* case in which it was finally concluded that the indexation and the currency clauses were unfair under Dir. 93/13/EEC because banks did not comply with their duty to inform clients of the exchange rate risk. However, while consumers will make more informed choices, they will still expect help by institutions in case they struggle because of currency fluctuations. There is a parallel question of mentality — an expectation for paternalism as well as an anti-bank sentiment which, to a different degree, thrive in Bulgaria, Croatia, Serbia, and beyond. Moreover, as explained below, although Dir. 2014/17/EU gives consumers the right to convert their loan, it is so vague on this point that it seems this solution cannot be implemented without institutional intervention.

33. Finally, the Croatian example of relying on a paper published on IMF’s website in 1997 to prove that lenders foresaw the appreciation of the Swiss franc but did not inform consumers when giving the loans raises concern that public policy and legal cultural values trump the letter of the law. If national judges are convinced that the bank should bear the loss because of legal cultural factors, they will find a way to reach this outcome. Chances are that one would be able to find an academic paper in which a particular scenario was examined, but which banks did not mention when explaining the risks of currency exchange.

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<sup>101</sup> E. MENDEZ-PINEDO, ‘Will the Directive 2014/17/EU on Mortgage Credit Protect Consumers in the Next Economic and/or Financial Crisis?’, 8. *JT (Juridical Tribune)* 2018 (2), p 582.

<sup>102</sup> *Ibid.*

## 5.2. Conversion

34. Chapter 9 of Dir. 2014/17/EU also contains rules on limiting currency risk. Its Article 23(a) entitles consumers to convert foreign currency loans under certain ‘specified conditions’. Alternatively, Article 23(b) obliges Member States to ensure ‘there are other arrangements in place to limit the exchange rate risk to which the consumer is exposed under the credit agreement’.

It has been highlighted that because of the way Article 23 is worded, ‘the final result of consumer protection at the national level will...largely depend on how individual Member States balance the protection of consumers’ interests on the one hand, and that of creditors on the other’.<sup>103</sup> Hence, it depends on how Dir. 2014/17/EU is transposed. In Bulgaria, for instance, Dir. 2014/17/EU was transposed in a new Law on Consumer Mortgages. Its Article 33(1) merely states that the consumer has the right to convert the loan. This means that the consumer should either negotiate with the bank individually or as part of a group. In that light, the Bulgarian experience of reaching two different deals on conversion with banks discussed above raises awareness of some of the risks this step entails. It may be the case that to enforce this option properly, if there is a crisis in the future, institutional intervention specifying the parameters of conversion may be indispensable to ensure fair and equal protection as well as legal certainty. In parallel, as seen above, Bulgaria adopted forward-looking conversion in the case of the Swiss franc surge while Croatia converted the loans from their inception despite a warning by the ECB. The former aims at loss apportionment while the latter attributes the losses to the banks. It seems that Member States will not apply this part of the Dir. 2014/17/EU uniformly, which would lead to divergent levels of consumer protection across the EU.

35. Besides, one cannot help but notice that borrowers in Bulgaria, Croatia, and Serbia were generally dissatisfied with conversion as a solution. In Serbia, few borrowers took advantage of the conversion options put forward by the central bank and litigated individually with the purpose of terminating the contracts. In Croatia, even those who took advantage of conversion are now seeking the nullity of the indexation and currency clauses based on the outcome in the *Franak* case. It seems that in these jurisdictions citizens expect a paternal approach by the State, which should prioritize their interests over the interests of the banks even though attributing significant losses to the banking system poses risks for the economy.

36. The alternative requirement under Article 23(b) that other arrangements limiting exchange rate risk be put in place also seems problematic. Recital 30 mentions ‘caps’ and ‘warnings’. Capped mortgages — mortgages at a variable interest rate which has a ceiling — are a very rare product, which is unattractive for lenders because it imposes risks on them, so this solution seems impracticable. In turn, while banks may warn clients that the interest rate has increased, borrowers must decide what to do which brings us back to the original issue that they would probably expect to be helped if they make the wrong choice. Ultimately, one is tempted to invoke the role of national central banks — when a given product linked to foreign

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<sup>103</sup> T. JOSIPOVIC, ‘Consumer Protection in EU Residential Mortgage Markets: Common EU Rules on Mortgage Credit in the Mortgage Credit Directive’, *CYELS (Cambridge Yearbook of European Legal Studies)* 2014, p 248.

currencies is popular on a large scale, it seems that national central banks are best placed to estimate the potential risks and to take measures by issuing recommendations or requiring the banks to convert these loans at an earlier stage. However, as seen in the case of Bulgaria, Serbia and Croatia, central banks may have different views about their own roles and dissimilar philosophies of what central banking entails.

37. Finally, while one may argue that exchange rate risk seems remote at this stage because the current move is to encourage borrowers from countries which are not part of the Eurozone to borrow in Euros if they want to avoid the risks of their national currencies, the Euro is not insured against fluctuations in the mid-term and the long-term. This is especially valid for Serbia which has recently seen the significant depreciation of the Serbian dinar against the Euro. In Bulgaria, the Lev is formally pegged to the Euro while in Croatia the central bank intervenes to minimize the deviation of the Kuna. These policies may always change due to political and economic factors. Hence, while we may be confronted with a similar scenario in the future, the current tools provided by Dir. 2014/17/EU seem insufficient to address it.

## **6. Conclusion**

38. The impact of the Swiss franc surge on Swiss franc mortgages poses complex questions in contract law, consumer law, and financial regulation, which cannot be conclusively resolved. It is not surprising that Bulgaria, Croatia, and Serbia struggled to identify the most adequate approach given the circumstances. Each of the three national responses has strengths and weaknesses. The Bulgarian CPC tried to balance the interests of borrowers and lenders, but at the end, their solution was untimely and inconsistent, which forced many consumers to fight for their rights alone. While beneficial for consumers, the Croatian retroactive conversion solution seems extreme — not only Croatia imposed huge losses on the banks, but also ignored ECB warnings. The additional blow, which the courts delivered under Dir. 93/13/EEC, raises further concerns. The Serbian central bank's response was the timeliest and most adequate, but not to the liking of borrowers, which left the fate of loans in the hands of the courts for a long time.

39. Unfortunately, the recent Dir. 2014/17/EU does not give much hope that the effects of currency shocks on foreign currency mortgages can be better handled in the future because, at least in the jurisdictions examined, borrowers expect to be helped by State institutions when they struggle. It seems that the best course of action remains timely institutional intervention, which is aimed at finding a good balance between the interests of lenders and borrowers, which complies with the principles of fairness and legal certainty, and which does not put the national economy at peril.