Poland: ECJ ruling on Swiss franc mortgages - an update

On Thursday, the ECJ renders its guidance on a Swiss franc mortgage case. We expect it to side with the debtor, suggesting the debt should be converted into Polish zloty at the original FX rate. This is nonbinding for Polish courts but should increase the number of such cases and encourage banks to hedge short CHF positions, thus affecting the zloty

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Verdict just ahead of the elections

In Poland, holders of foreign currency mortgages are attempting to invalidate them in court, citing abusive clauses. They want to push the cost of the zloty's depreciation since 2008 onto banks. Due to a discrepancy in local court verdicts, the Court of Warsaw asked the European Court of Justice for guidance.

During an investor trip to Warsaw, we had a series of talks with lawyers and the parties involved, helping us to refine our view. Our key conclusions:

- The ruling is a risk for the Polish zloty. It is scheduled just ahead of general elections so the response from authorities may be muted. The lack of communication from authorities may encourage speculators to bet against PLN on the expectation that banks will pre-emptively hedge short Swiss franc positions resulting from the conversion of mortgages to zloty.
- EUR/PLN is likely to hover around 4.40 for a lengthy period, with the zloty remaining undervalued due to persistent bids for CHF, which will be needed to close the PLN130 billion FX mortgage portfolio. Our models suggest a fundamental EUR/PLN level of 4.20-25.
- PLN, to some extent, is already pricing in an ECJ ruling against the banks. We think the trigger for further transitory PLN weakness will be the follow-up lawsuits in Polish courts rather than the ECJ ruling, per se. A strong rise in the number of clients suing banks may spur further worries about FX losses, new provisions and FX hedging. After a period of stress, regulators will likely help banks to settle with their customers. This should mitigate the negative consequences of the FX mortgage conversion for bank profits, financial stability, credit supply, GDP growth and budget revenues, which nobody wants to undermine.

PLN130bn Outstanding FX mortgages

The ruling to encourage more court cases

- The ruling merely provides guidance and is non-binding for Polish courts. Still, based on comments by the ECJ's spokesman and an ECJ ruling on consumer loans, we think the court will probably side with debtors. This should support the already existing position of Polish courts. Since the beginning of 2019, courts sided with debtors in 88% of cases (of the first instance), as opposed to 2016-17 when they sided with banks in 70-74% of cases (of the first instance). Both the ECJ ruling and the current approach by courts will likely encourage debtors to sue banks. Currently, only 2% of all FX-mortgages are disputed in courts. Still, in the first half of this year, the number of new cases rose by 40% year-on-year and this number is likely to grow quickly.
- The court's ruling on other types of FX mortgages (denominated as opposed to FX-indexed, which are the subject to ECJ guidance) has yet to be clarified. Most (if not all) of these loan contracts contain some form of abusive clauses, suggesting grounds for disputing them in courts and rising odds of clients winning against the banks. Overall, the volume of FX mortgages is PLN130 billion, but lawyers we've talked to expect that some expired products could be disputed as well (PLN160bn in total).

Hit for banks' profits, PLN negative

- The creation of provisions for future FX losses is a factor that could burden banks' current profits. It could also speed up the hedging of short CHF positions caused by unwinding FX mortgages.
- Comments from authorities and banks suggest that provisions should be made as new cases enter courts, rather than pre-emptively on the whole FX-mortgage portfolio. The “case by case” approach to the creation of provisions should spread potential losses over several years. However, banks are still likely to pre-emptively hedge part of their FX position,

as a further rise in CHF/PLN would result in higher future losses/provisions.

- Banks are unlikely to seek settlement outside of court just yet – potential losses are too big, the number of cases is relatively low and potential claims expire after 10 years. We see some parallels between CHF mortgages and unit-linked insurance offered by insurers. In a similar case, insurers waited until about 20% of transactions were disputed in court before they decided on a kind of middle ground solution.
- Unlike the conversion of FX mortgages in Hungary, the process in Poland will not take place in a single day. Instead, it should be rather lengthy, so it would be difficult for the central bank to provide foreign currency for the conversion process.

- The National Bank of Poland may tolerate some PLN weakness; we don't expect any intervention below 4.60. A depreciation of the zloty may be a tool to offset worsening external GDP growth, which is increasingly worrying. At some point, signs of a weakening in eurozone domestic demand will hit Polish manufacturing and GDP growth.
- Eventually, banks are likely to propose a kind of conciliatory solution. Some 20-25% of the claims will be eaten up by lawyers' fees, benefiting neither bank nor client. Also, changes in the legal system enable debtors to sue banks in multiple locations - bank lawyers will eventually become overwhelmed. A settlement would be a good moment for the central bank or regulator to consider a kind of systemic solution.
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