

## The Polish FX-mortgage saga is back with PLN and POLGBs at risk

The European Court of Justice is to give guidelines for Polish courts on FX mortgages, likely siding with debtors. Banks may face substantial losses, forcing many to recapitalize and possibly hedge some FX positions stemming from such loans. This is a clear risk for PLN and potentially Polish Government Bonds too



A luxury apartment block in Warsaw

### The trouble with FX-mortgages: a quick recap.

Polish banks ceased to offer FX-denominated mortgages in 2012. However, outstanding credits, currently around PLN130bn (EUR30bn), still pose a significant risk to the Polish banking sector. Costs resulting from the rise in CHF/PLN were paid by creditors, but capital, regulatory and reputational costs of having such loans in the banking books grew as well.

President Duda pledged to convert those mortgages to PLN at original FX-rates. Eventually, in July 2019 parliament decided not to enforce that solution, rather putting the focus back on debtors in poor financial situations (with very low cost for banks).

# 60-80bn

## Potential losses for the Polish banking sector

in PLN

### European Court of Justice to side with FX-debtors

Given the meagre support from the government, people with FX-mortgages decided to sue banks for damages in court. They usually argued that various parts of the mortgage agreements (i.e. the formula for calculating interest or low down-payment insurance, FX spreads or even the FX-denomination mechanism itself) were abusive and should be changed or removed. Most of those trials are still ongoing.

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#### *People with FX-mortgages decided to sue banks for damages*

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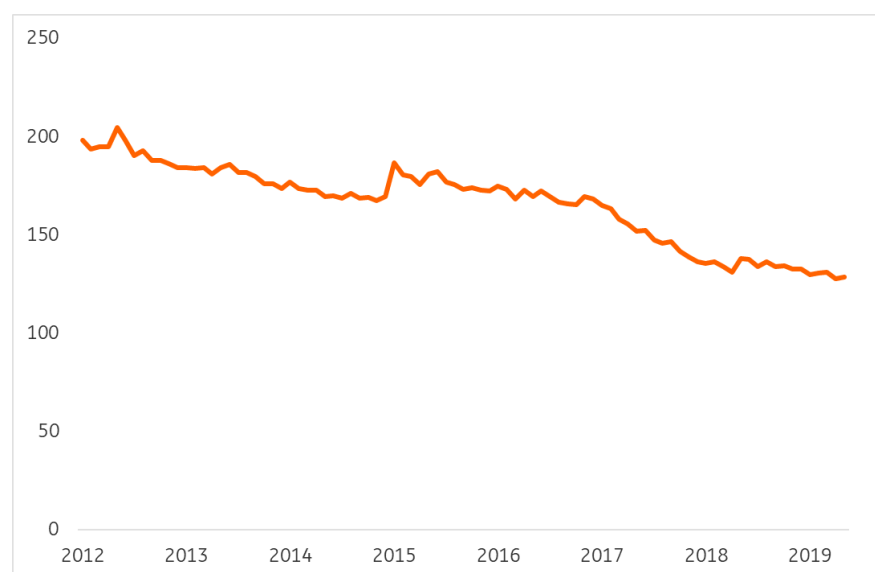
In the handful that are over, court judgements have been very inconsistent. Around half supported the plaintiffs and the other half sided with the banks. In some rulings, courts demanded the conversion of loans to PLN (at the original rate) but changed the base interest rate from LIBOR to WIBOR. In other rulings, courts cancelled whole mortgage agreements. Due to this discrepancy in verdicts, the Court of Warsaw asked the European Court of Justice for guidelines on what it should do when it recognises a particular clause in a loan-contract as abusive.

The ECJ's judgement is expected soon (between September and November). However, the Court's spokesperson has already announced what it most probably could look like. The ECJ is expected to say that when a Polish court finds an abusive clause in a loan-contract, it should either (1) remove the clause and change nothing else, or (2) judge the contract was non-existent (especially if that judgment is beneficial for the customer). In the first case, if the remaining agreement is still workable it should remain binding, especially when it is favourable to the customer

What does it mean in practice? Consider what would happen if a court were to find an FX-denomination clause in a mortgage agreement abusive. If it removes it from the contract, the mortgage will be converted to PLN with the FX-rate prevailing at the date of loan origination. However, the interest will still track LIBOR, not the price of PLN (WIBOR). This isn't just a theoretical scenario as a couple of such verdicts have already appeared in courts.

In the second case, when an FX mortgage contract will be deemed as non-existent, the bank should also close its FX exposure in order to unwind funding in CHF and reconcile with clients. In both cases, the FX mortgage is converted to PLN.

## The value of FX-mortgages in the Polish banking sector, PLNbn



Source: Banking Association Survey

### Dire consequences for the Polish banking sector

If such rulings become widespread, encouraged by the ECJ guidelines, they might cause significant losses to Polish banks. In an extreme case, if all of the existing FX-mortgages were to be converted to PLN at the original rate and interest remained LIBOR-based, the cost for the banking system in Poland might reach PLN60-80bn.

These losses won't happen overnight and their full scale is highly uncertain as the ECJ guidelines aren't a substitute to the rulings of individual Polish courts. It will be still up to them to decide case by case, which will take years. The likelihood of verdicts which are unfavourable for banks will probably increase, but it is difficult to say by how much exactly. So far, around 10-thousand people out of 500-thousand FX-debtors went to trial. However, their number should grow rapidly when the probability of favourable rulings for clients rises as a result of the ECJ guidance.

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*Banks could be forced to reduce credit supply dramatically in order to improve their capital positions*

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That is why the ECJ ruling might hit Polish banks much faster if they are forced to build reserves for litigation losses. Auditors might explicitly ask for such reserves, especially if the number of lawsuits related to FX-mortgages starts to snowball and the likelihood of banks losing them exceeds 50%. In such a case, most of the banks in Poland would require recapitalisation because the size of required reserves would likely exceed (several times) their annual profits.

The Polish Financial Authority might provide some assistance to the banking sector by lowering the capital requirements (some of the buffers were created for the sake of CHF-risk). However, in our opinion, the amount of capital released this way will not be sufficient. So banks could be forced to reduce credit supply dramatically in order to improve their capital positions. In short, should the

ECJ guidance be unfavourable, banks could start freezing credit lines for several quarters, which could lead to a painful GDP slowdown.

## What does it mean for financial markets?

The costs of litigation in question are dependent on the CHF/PLN exchange rate (the higher it is, the higher the losses of the banks). This poses a significant risk for banks because there is a high chance that CHF/PLN will grow over time, especially when Polish courts start to issue actual verdicts aligned with the ECJ guidelines. Some banks might want to hedge this cost by buying CHF upfront. Therefore, we could see significant PLN depreciation in the coming quarters.

The ECJ ruling is also rather negative for POLGBs, but the impact is less clear cut. On the one hand, banks' growing reserves will create demand for Polish debt (you need to hold your reserves in something). On the other, a sharp rise of reserves should force banks to freeze the credit supply to the economy for a few quarters, which should depress GDP growth and pose the risk of a higher general government deficit and additional borrowing needs. All should increase the credit risk premium embedded in the POLGBs and subsequently raise yields.

## How can this can be mitigated?

The previous FX mortgage story from 2016 was equally risky for the banking sector and caused a major weakening in PLN and POLGBs. But at the end of the day, policymakers (Financial Stability Committee with new NBP governor Adam Glapinski) persuaded politicians to withdraw from the project as the potential hit to the banking sector, economy, fiscal side, PLN and POLGBs was very high. We don't know whether the same rational approach will be applied this time around. The longer the ECJ debates on the final guidance (e.g. in order to encompass FX loans cases in other member states), the more likely the 'hot' election period in Poland will pass and politicians will decide to find a kind of middle-ground solution for CHF-mortgages.

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