Poland: ECJ guidance on FX mortgages casts shadow over the zloty

On Thursday, the European Court of Justice (ECJ) is expected to present an opinion on whether or not banks may charge interest on Swiss franc mortgages that were terminated by the court. A negative verdict could cost the banking sector up to PLN100bn. This is an important tail risk for the zloty and Polish government bonds

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Background

The Swiss franc (CHF) mortgage battle, between borrowers and Polish banks, rages on. A new phase may be initiated on Thursday when the ECJ spokesperson is expected to give guidance on the upcoming ruling on a settlement between parties when a credit contract is invalidated. Polish banks have been struggling with FX mortgage loans unwinding and have been burdened with high provisioning in recent years, now reaching almost PLN30bn. Even though there is no law of precedent in Poland, prevailing rulings of domestic courts are predominantly in favour of borrowers and against banks as courts found abusive clauses (e.g. unclear currency-linking mechanisms) in contracts and terminated them. In the instance when the loan contract is terminated, the borrower returns the zloty equivalent of FX mortgage capital and parties settle on the exchange rate that splits the exchange rate impact on obligations. Based on statistics provided by law firms, debtors suing banks over FX mortgages win more than 90% of lawsuits, usually achieving invalidation of the loan contract. As a result, the borrower is obliged to return the borrowed amount in Polish zloty (PLN). This already generates significant FX losses for domestic banks due to the rise in CHF/PLN since 2005-09, when the bulk of such loans originated.

What's on the table

The ECJ was asked by a local court whether or not banks should receive interest on a mortgage capital even when the loan contract was invalidated by the court due to abusive clauses. Domestic courts are still struggling to judge how mutual obligations should be resolved if the loan is ruled to be invalid. Banks claim that borrowers should pay interest for the time the money was available to the borrower. The ECJ may take a pro-consumer approach and decide that creditors (banks) should bear all the consequences of wrongdoing in loan contracts and hence not be allowed to charge interest on FX mortgage capital that was ruled by the court as invalid.

Potential implications for banks

According to the Polish Financial Supervision Authority (KNF) estimates, a verdict that is fully negative for the banking sector (i.e banks are owed no interest at all) could trigger losses of circa PLN100bn, or around 50% of the banking sector's own funds. In the last few years, banks have made provisions of PLN30bn. According to banks with sizable FX mortgage portfolios, they have made provisions for potential FX losses on terminated Swiss franc mortgages, but still need to add more provisions for potential losses in the instance that they are not allowed to charge clients for the use of mortgage capital. Recently banks accelerated provisions creation, but are still far from 100% coverage. They simply assumed that free use of mortgage capital does not make sense.

Potential macroeconomic and market impact

Unfavourable ECJ guidance is an important systemic risk for the banking sector given the scale of the financial hit for exposed banks. It could challenge the stability of the Polish financial system (if banks were forced to make provisions in a short period of time), meaning a significant risk for both the Polish zloty and Polish government bonds (POLGBs). The main way an unfavourable ECJ verdict will hit POLGBs is by lowering banks' capacity to fund government borrowing needs and less demand for POLGBs triggering higher yields.

On the other hand, the experience with the first part of the Swiss franc loans saga is that when banks are allowed to create provisions gradually, on a sustainable basis, that limits the systemic risk for the financial sector. In current circumstances, should the ECJ's opinion prove to be balanced and banks are allowed to add a new provision on a sustainable basis, that would limit the systemic risk.

Also, given the systemic risk for banks and POLGBs, we can imagine local authorities coming up with some mitigating measures in case the ECJ guidance proves to be unfavourable for banks.

It is difficult to estimate to what extent the aforementioned risks have already been priced-in, but it should be noted that so far in 2023 the zloty has underperformed all CEE counterparts. Since 2022, PLN has lost more than 2% against the euro, just over 3% against the Romanian leu and more than 5% against the Hungarian forint. While there are probably other factors involved, the ECJ verdict seems at least partially to be a factor behind such rate developments. As such, guidance that is not strictly negative for banks (e.g. leaving decisions to local courts) may prove to be positive for the zloty and POLGBs.

Finally, there is an economic risk as well. While demand for credit is currently very low (particularly on the household side), it is likely to rebound in the coming years, especially when Poland starts tapping another bulk of EU funding. Therefore, negative ECJ guidance and the difficult capital position of domestic banks could potentially limit credit access in the long run, particularly to consumers and smaller companies.

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