

Q&A for the Thoughtful Bank Investor

Polish banks: no catastrophe expected from ECJ ruling



Scope
Ratings

Polish banks face potentially significant risks with respect to their foreign-currency mortgage portfolios, pending a European Court of Justice (ECJ) decision on indexation clauses. That said, while the impact of an adverse ruling could be substantial for some lenders, any negative effects will likely be spread over years, partially mitigating any fallout. Even in an extreme scenario, not the central Scope base-case, we would expect political or regulatory intervention if banking system solvency were to come under stress.

Short recap

Polish banks extended housing loans in foreign currencies between 2005 and 2012, with outstanding debt now standing at PLN 124bn (EUR 28bn). The bulk of the debt, mostly mortgages denominated in or indexed to Swiss francs, was originated between 2007 and 2009 when the significant difference in interest rates and favourable exchange rates made these products highly attractive. Interest on CHF loans during this period was almost half that of zloty loans.

Since mid-2008, however, the PLN has almost continuously depreciated against the CHF, with a trough in January 2015, following the decision by the Swiss National Bank to remove the EUR-CHF peg, putting increasing pressure on borrowers to service their debt.

Why are we talking about this now?

In recent years a number of legislative proposals forcing conversion of such loans – with banks bearing the cost – were put forward but later abandoned.

Renewed attention on the issue followed the publication in May 2019 of a non-binding Opinion from a European Court of Justice Advocate General on the consequences of declaring indexation provisions in mortgage contracts as unfair.

The opinion was issued after the Warsaw regional court, asked to decide on a lawsuit against RBI's Polish branch, referred four questions to the ECJ for a preliminary ruling. A final verdict on the matter is expected at any moment. Despite not being binding, in most cases the Court follows the Opinion submitted by the Advocate General.

What could this mean for Polish lenders?

A verdict in favour of the plaintiffs will likely result in an increasing number of lawsuits brought against Polish lenders.

So far, national courts have sided with banks on a number of occasions. However, the ruling would constitute an important precedent. Two clarifications have to be made: 1) the decision only pertains to contracts whose terms have been found to be abusive and 2) the decision pertains only to contracts containing indexation clauses; this second point being more relevant in estimating the impact on Polish banks.

According to the preliminary opinion, determination of unfairness could translate either into such provisions being removed, meaning converting the mortgages to PLN at the exchange rate at origination with interest being still Libor plus a margin, or annulment of the contract, especially if it benefits the consumer, de facto also forcing a conversion.

Indexation means in essence that the loan was deemed to have been disbursed in PLN, the remaining balance calculated in CHF with instalments also expressed in CHF but debited in PLN; in short, no CHF exchanged hands.

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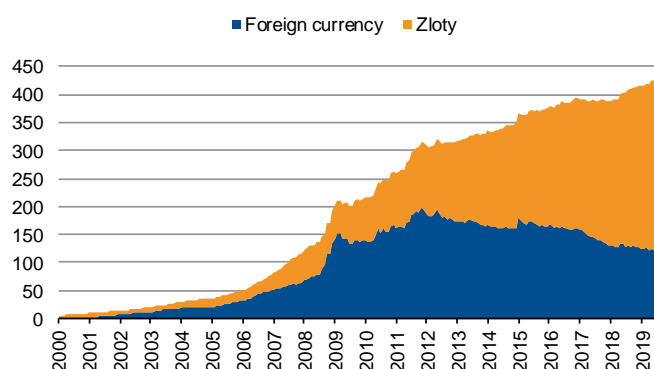


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What numbers are we talking about?

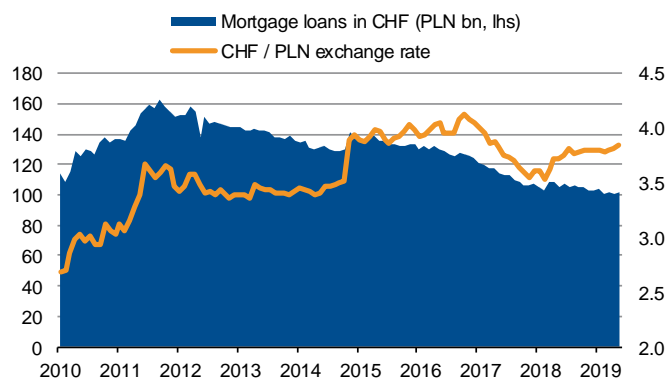
If we take the entire outstanding amount of housing loans denominated in Swiss francs, ca. PLN 100bn or 5% of banking assets as of July 2019, a forced conversion today might cost ca. PLN 44 bn (EUR 10bn) or 3.4x Polish banks' annual profits. This is an extreme scenario.

Figure 1: Bank loans for house purchase (PLN bn)



Source: NBP

Figure 2: CHF mortgage lending and exchange rate



Source: NBP

The Polish Financial Supervision Authority (KNF) estimated the share of indexed loans at 55% of total FX-denominated loans. The value at risk, on which the banks will have to provision, will be a function of how many borrowers sue.

The problem of foreign currency loans is prominent in the CEE region, notably in Hungary, Romania and Croatia. Lenders in these geographies were already at the centre of decisions from the ECJ regarding the fairness of FX contracts clauses, while in Spain the Court was called to decide on rate-floor clauses in mortgage contracts.

In 2014 in the “Kasler” case against Hungary’s OTP Mortgage Bank, the Court ruled in favour of the plaintiffs on the unfairness of fee structures on FX loans and substituted terms with provisions of national law (in this case re-linking loan payments to the official exchange rate set by the National Bank of Hungary). The Kasler case is referred to in most subsequent similar judgments or opinions on mortgage clauses, including the opinion issued by the Advocate General in the Polish case.

In December 2016, the ECJ ruled “floor clauses” to be null and void after borrowers challenged a Spanish Supreme court decision that, despite ruling such provisions illegal, limited the effects from May 2013 onwards, strongly reducing the extent to which borrowers could claim for restitution of sums already paid. At the time, the Bank of Spain estimated compensation costs for banks at EUR 4bn. Also, interestingly enough, in this case the ECJ didn’t side with the preliminary ruling of the Advocate General, who agreed with the Spanish court decision.

How will individual banks be affected?

On a bank by bank perspective, Bank Millennium, the Polish subsidiary of Banco Comercial Português, has a significant amount of CHF denominated loans, ca. PLN 15bn as of H1 2019.

mBank, the subsidiary of Commerzbank, follows closely with PLN 14bn. As neither of these lenders discloses what share of the overall portfolio is indexed, Scope uses the KNF estimate of 55% and assigns a 50% probability of a negative outcome, partially because provisions are taken when a certain outcome becomes more probable but also because not everyone will sue and not all contracts will be deemed to include abusive clauses.

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Under the assumptions above, the impact on the profitability of both lenders would be severe. However, the timing of the court decision could help spread the impact of the increase in provisioning over a number of years.

Santander Bank Polska (SBP) and, especially Powszechna Kasa Oszczędności Bank Polski (PKO), are better positioned. As of H1 2019, SBP reported ca. PLN 8bn of CHF loans, either indexed or denominated, and disclosed that the share of indexed loans on total FX stands above 80%. As above, this would mean ca. PLN 270m cost p.a. or a drop of 110bp on the bank's ROE.

PKO extended most of its CHF-indexed loans between 2010 and 2012, when, compared to 2008, the Swiss franc had already significantly appreciated. Combined with the fact that the bank's portfolio is significantly smaller, PLN 3.4bn as of H1 2019, the P&L impact would be manageable.

Table 1: Millennium and mBank situation might require significant provisioning

| | CHF indexed loans (PLN bn) | Cost of conversion (PLN bn) | Provisioning p.a. (@ 50% prob over 5 years) | Impact on ROE |
|------------------------------|-------------------------------|--------------------------------|---|------------------|
| Bank Millennium* | 8.27 | 3.57 | 0.36 | -450bps |
| mBank* | 7.61 | 3.29 | 0.33 | -220bps |
| Santander Bank Polska | 6.34 | 2.74 | 0.27 | -110bps |
| PKO | 3.40 | 0.56 | 0.06 | -20bps |

*assumption that 55% of CHF loans are indexed
Source: Banks' disclosure, Scope calculations

Are there other initiatives?

A draft bill including provisions for financial support for voluntary restructuring of FX loans was put forward in the summer but later abandoned.

The draft had proposed to extend the scope of the Borrowers Support Fund, created in 2015 to help borrowers, irrespective of the currency, and initially financed by lenders with PLN 600m. This proposal would have required banks with FX exposures to contribute up to 0.5% of their FX-denominated or indexed portfolios every quarter (adding an additional PLN 600m per quarter).

In an opinion on the draft law issued by the ECB in November 2017, the last of four different legislative proposals from the Polish Parliament later abandoned, the Bank pointed to the recurring nature of the financial impact on banks given the lack of time or size limit for contributions into the fund. Moreover, the increase in maximum per capita income threshold for requesting financial support could have created a moral hazard issue on the side of the borrowers.

Despite not being perfectly designed, this solution would have spread the impact on banks' profitability, while still over time contributing significant sums into the fund. In five years, the fund could have covered 1/3 of the cost of a forced conversion of the total FX outstanding.

Instead, the Polish parliament opted to leave the matter to the ECJ and to individual court decisions, although ex-post a better-designed fund would have achieved a similar outcome while removing uncertainty from a lender, but also partially from a borrower's perspective. We would expect such proposal to be reconsidered if needed, likely after the general election in October 2019.

Conclusion

Lenders with FX exposures in Poland are already subject to higher capital requirements under Pillar I arising from increased risk-weights. Moreover, the KNF individually sets an additional capital requirement under Pillar II to cover credit and other risks linked to FX loan portfolios.

We do not expect a final ruling from the ECJ on the consequences of abusive clauses to have a catastrophic effect on the Polish banking system. However, for some lenders the impact on profitability might be significant, even if spread over time. Macroprudential measures could be adjusted if needed, especially if bank capitalisation comes under stress.



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