Q&A for the Thoughtful Bank Investor

IRPH-linked mortgages add to litigation risk for Spanish banks but likely impacts manageable

In this short Q&A report, we sum up the essentials of IRPH-linked mortgages and explain why we believe the impact of this week's ECJ ruling is more contained than many observers fear.

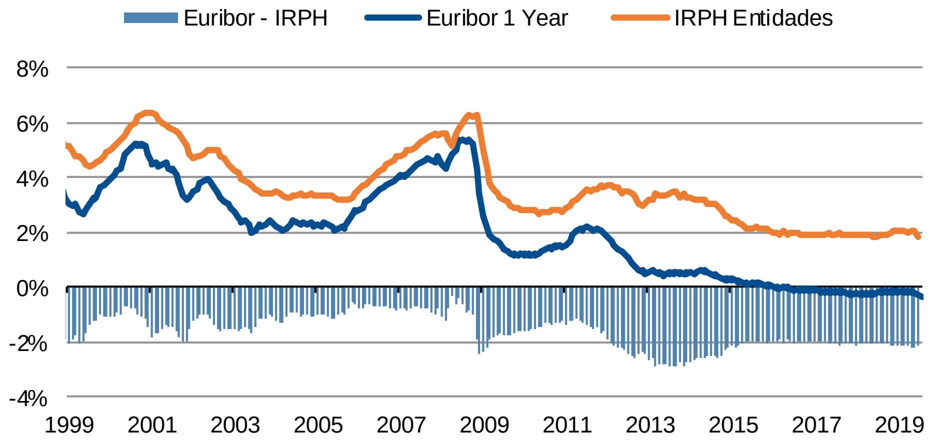
What is IRPH?

IRPH –Indice de Referencia de los Prestamos Hipotecarios (Spain's mortgage rate index) – is an official index created in 1994 and compiled monthly by the Bank of Spain. It is one of the most widely used mortgage reference indices in Spain along with one-year Euribor and to a lesser extent the five-year swap rate. The IRPH is based on the effective average three-year cost of mortgages offered by Spanish banks. Its introduction was meant to create a stable reference rate for mortgages by smoothing out Euribor volatility.

Why should investors care about IRPH?

Since the Spanish real estate crisis, the IRPH has declined less than Euribor with the gap between the two averaging 2% in the past decade. Borrowers with an IRPH-linked mortgage therefore missed out on the windfall from falling rates, felt deceived and have started suing the banks.

Figure 1: Euribor vs IRPH historical evolution (1999-2019)



Source: ECB, Bank of Spain

The two reference indices are not entirely comparable: Euribor is a money-market rate and therefore does not reflect LTVs and customers' credit risk. Mortgage pricing typically reference Euribor, but banks add a significant credit spread. Conversely, the IRPH is an average of all-in mortgage interest rates, which include an element of credit risk. Hence it is normal for the IRPH to be higher than Euribor and for the spread to fluctuate, reflecting changes in the yield curve and banks' pricing of mortgages.

Having been sold mortgages linked to the IRPH instead of Euribor, many bank customers felt deceived. The issue has been discussed in several Spanish courts, and in December 2017, Spain's Supreme Court ruled that mere reference to the IRPH index does not by itself imply lack of transparency or mis-selling. The decision was deferred to the European Court of Justice (ECJ). On 10 September 2019, the ECJ's Advocate General stated that Spanish banks may have violated the EU's 1993 Directive on unfair terms in consumer contracts by using the IRPH index.

However, any claims will have to be decided by Spanish courts on a case-by-case basis. The Advocate General's decision is not binding but the final ruling due by the end of the year is unlikely to substantially differ.

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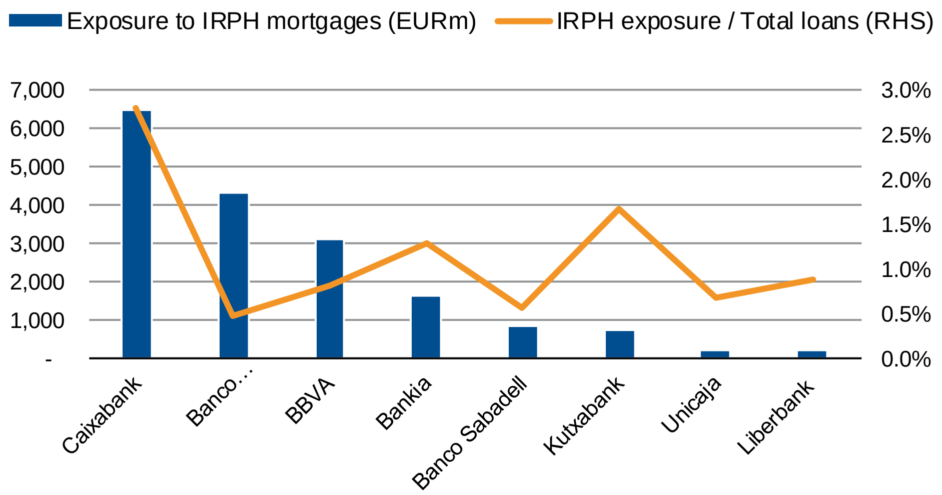
Has any bank commented on the issue?

Yes, most banks (Banco Santander, Caixabank, Bankia, Banco Sabadell and Kutxabank) have disclosed their exposures to IRPH-linked mortgages. As of Q2 2019, the top eight Spanish banks (Banco Santander, BBVA, Caixabank, Bankia, Sabadell, Kutxabank, Unicaja and Liberbank) had EUR 17.4bn of IRPH mortgage exposure, with Caixabank alone accounting for EUR 6.4bn. However, current exposures give no indication on how many mortgage contracts, including matured mortgages, the banks have written based on IRPH. This number does not include mortgages that have been repaid. Prior to the ECJ opinion, the Bank of Spain commented in its financial stability report that the dispute could prove costly to the banks, both in terms of compensation and reputation.

Figure 2: Main Spanish banks' current exposure to IRPH-linked mortgages



Source: Company info, Scope estimates

What sums are potentially involved?

As with any legal contingency, it is difficult to estimate the impact until the process comes to an end. Elements of uncertainty include, among other things, the number of affected customers, how many of them will try to claim, how many claims will be successful and for what amount. Should judges void the clause referring to IRPH, it is also not clear what rate they would replace it with and on what legal basis. Another open question is whether judgements can be applied retroactively especially to mortgages that have already been repaid.

This partly explains the wide range of market estimates from sell-side analysts and consumer associations, which go from a few billion to several tens of billions. For example, consumer association ASUFIN has stated that up to one million customers could be affected, with an average cost per customer of EUR 25,000. This would put the total potential liability for the banks at EUR 25bn.

Can we draw lessons from previous litigation cases?

Based on previous history, we believe the final hit to banks will be lower than suggested by ASUFIN. For example, banks faced similar challenges in the past with respect to mortgage floors (*clausulas suelo*), with the courts deeming the clauses void, forcing the banks to pay back all interest retroactively. Out of 1.2m claims received since 2017, fewer than half have been admitted to the extrajudicial process mandated by the government to speed up proceedings. As of January 2019, total customer redress amounted to only EUR 2.2bn. New claims inflows have now reportedly slowed to a dribble and in only 6.5% of the admitted cases a settlement could not be reached.

Scope's view and impact on banks

We believe the final impact will be lower than many observers fear. Assuming that Advocate's General stance is adopted by the ECJ, it would then be up to local courts to rule on IRPH clauses on a case-by-case basis unless an extrajudicial procedure is established.

However, given that the IRPH is a widely-used official index, we think that proving mis-selling should be harder than in the case of the much less transparent mortgage floors. Moreover, we note that not all affected customers are likely to file claims and it is not clear how far back the courts will rule retroactively. For example, so far is fewer than a third of eligible customers have filed any claims related to mortgage floors.

Taking the ASUFIN numbers as a basis for our estimate and assuming that only a third of affected customers make a claim with a success rate of 40% (in line with the mortgage clause data where less than 50% of claims were admitted), we come to a potential liability of EUR 3.3bn. While there remains considerable uncertainty over the claims, such an amount would represent a small nuisance and a drag to profitability for the sector but should not concern credit investors.

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