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Poland Economics View

Return of FX mortgage saga

- The theme of FX mortgages in Poland is coming to the fore again. This time, however, it is not because of steps taken by the Polish authorities but due to a rising risk of FX mortgage litigations.
- In the note below we try to answer some of frequently asked questions regarding FX mortgage conversions and their impact on Polish economy and markets.
- We argue that both economic and market consequences are likely to be limited because conversions of FX mortgages will most likely be spread over very long time.

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Return of FX mortgage saga

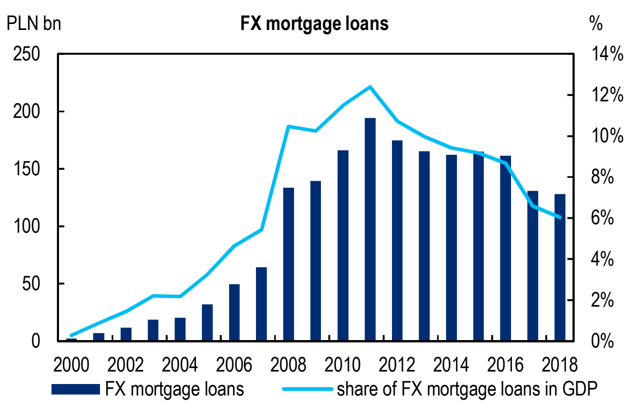
The theme of FX mortgages in Poland is coming to the fore again. This time, however, it is not because of steps taken by the Polish authorities but due to a rising risk of FX mortgage litigations. The Court of Justice of the European Union (CJEU) is expected to announce its ruling in Polish FX mortgage-related lawsuit later this year. Based on already published non-binding opinion of the Advocate General of CJEU it is likely that the ruling will be negative for banks and positive for indebted households.

Below we try to answer frequently asked questions regarding the risks related to FX mortgages in Poland and their implications for economic growth and markets.

What can the EU Court of Justice decision change in status quo?

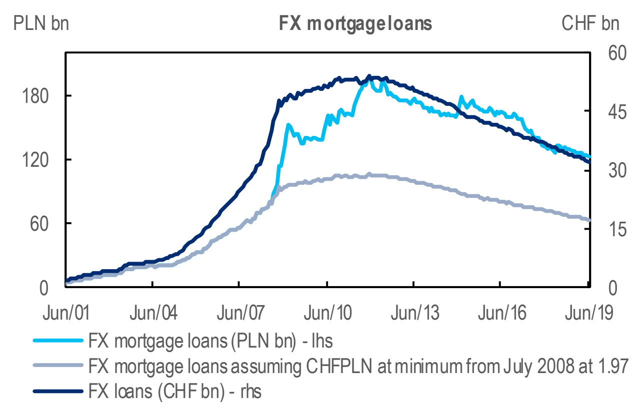
Regardless of the verdict, the ruling of the CJEU does not have immediate and direct impact on Polish law. In particular it would not make existing FX mortgage agreements invalid, nor it would imply an automatic conversion of all FX loans to local currency. However, the ruling can and probably will be used by Polish courts as a guideline in their future verdicts. It could also lead to a higher number of court cases as clients might feel encouraged by the ruling of CJEU (as well as by the earlier resolution of Polish Supreme Court, dated June 2018). As our colleagues covering Polish banks argued in the past, the number of litigation cases have been rising for some time. Taking this into account the CJEU ruling might become an important trigger that would accelerate the trend in the future.

Figure 1. Outstanding value of foreign currency mortgages amounts to 6% of GDP, a half of their 2011 value



Source: NBP, Citi Handlowy Research.

Figure 2. New FX mortgages are not issued anymore and therefore the outstanding falls as "old" loans are being repaid



Source: NBP, Citi Handlowy Research

What are possible outcomes of court cases?

There is no reliable and consistent statistics on the number of FX mortgage cases but local press repeatedly informs about a rising number of rulings that are favourable for clients. According to verdicts of some courts, the FX-indexed mortgages (in which the loan value was expressed in Polish zloty but was indexed to foreign exchange) should be deemed a local currency loan but with a Libor-linked interest rate. This means such an FX mortgage needs to be converted by a bank into local currency at a historical, below-market exchange rate. Yet the interest rate paid by a client remains as if loan was expressed in foreign currency. Loans of this type constitute approximately two thirds of FX mortgages in Polish banking sector.

In turn loan contracts in which loan values were expressed in foreign currency (i.e. FX-denominated loans) should be, according to some court rulings, deemed invalid. In that case a clients should repay the original nominal value, while the bank would need to close its FX position.

How long can it take to resolve FX mortgage issue?

According to KNF, Polish banking sector regulator, there are currently 555.9 thousand foreign currency mortgages, including 457.3 thous. CHF mortgage loans. It is uncertain how many litigations related to FX mortgages already started or are about to start but we think it is still a relatively small number (our guess estimate would be up to 5% of the total). Currently it takes up to two years to get a final judgement in court cases but assuming that a number of litigation rises substantially, the courts may be overwhelmed by new work. Taking this into account, as well as the fact that clients' decisions to start litigations may be spread over time, the period needed to fully resolve FX mortgage issue in Poland would probably be counted in decades.

Figure 3. FX mortgage statistics (2018)

	Outstanding (PLN bn)	Number	% of GDP	Average value (PLN thous.)
FX mortgage loans	128610	555937	6.1	231.3
CHF	104768	457276	5.0	229.1
EUR	22254	91078	1.1	244.3
Other currencies	1588	7583	0.1	209.4

Source: KNF, Citi Handlowy Research. Note: Values as of December 2018.

What would be an economic impact of FX mortgage litigations and conversions?

The consequences of FX mortgage litigations will depend on a number of factors, some of which are highly uncertain. These include a number of clients ready to go to court, the pace at which it will happen, the actual success rate or a potential response of authorities. Assuming that all clients go to court and win, the cost of FX mortgage conversions for banks can be large and Citi analysts estimate it at around PLN 60bn or 2.7% of GDP. However, the most important factor that may mitigate unfavourable *macroeconomic* consequences is related to the pace at which courts will be announcing verdicts, which – as argued above – is likely to be slow.

From the point of view of banks, the conversion of foreign currency loans at below-market exchange rate means the institution would need to incur losses on its mortgage portfolio. The loss would depend on how much weaker the PLN is versus historical levels (currently CHF/PLN is 3.95 vs. 2.09 in June 2008). Unlike in the past, when Polish authorities considered a possibility of a forced conversion of all FX loans in one shot, this time the whole process would be spread over a possibly very long time. This means every year banks would book losses on a relatively small portion of the portfolio, depending on a number of cases lost. Assuming that only ~5% of clients have decided to take cases to courts and that it will take up to two years to get final ruling, the first noticeable (but still relatively limited) losses will be recorded only after 2020.

Losses incurred by banks would likely contribute to a slowdown in lending as institutions would need to protect their capital ratios. Currently the annual lending growth is equivalent to around 3.5-4% of GDP which means the significant slowdown in credit growth could be an important negative impulse for the economy. However, as argued above, significant losses are unlikely to be booked by banks in the near term and therefore the slowdown in credit expansion and thus the impact on GDP seem to be more of a topic of 2021-2022 rather than 2019. Although clients winning court cases are likely to benefit from lower debt burden, the NBP statistics suggest these are households with higher-than-average incomes and therefore probably also lower-than-average propensity to consume. Therefore we doubt this change could generate a growth boost that would be enough to offset the negative impact of slower lending growth.

Taking this into account we expect the negative impact of FX mortgage conversions on GDP growth will be marginal in 2019-2020. It may become a more important factor in the following years, shaving even up to 0.5% point from the annual growth rate starting from 2021. However, taking into account large uncertainty such prospects are not yet reflected in our post-2020 growth forecasts.

Market implications

As far as FX and liquidity conditions are concerned the key risk would be related to banks' decisions to convert FX loans to local currency in a short period. However, once again the fact the whole process is going to be spread over time, rather than concentrated in one shot, means the risks to the market should be mitigated.

A bank whose clients started court litigations is able to monitor the progress of court proceedings and adjust to the changing situation. A prospect of 5% of mortgage loans being converted to PLN over next two years does not imply a need to adjust bank books anytime soon. The funding of FX lending has a probably much shorter maturity than mortgage loans (2-5 years instead of 30 years) and therefore the banks should be able to change the financing structure accordingly without putting any significant pressure on the funding market. Furthermore, FX mortgage issues may be neutral for government bond market. That is because the risk of mortgage conversions seems to have limited impact on Poland's fiscal position and, if anything, it may even increase banks' demand for government bonds as the institutions will prefer to hold risk-free and liquid assets.

The biggest uncertainty is related to the FX market. Given that weakening of the zloty versus CHF increases potential losses on FX mortgage conversion, an important question is whether banks will be willing to hedge against PLN depreciation. Taking into account the pace at which FX litigations progress, we do not think the banks are in a hurry to hedge. However, if for some reasons PLN starts to depreciate against CHF at a fast pace, the local banks may be urged to buy FX to limit potential future losses. All in all, the prospect of mortgage conversions changes the dynamics of the market, making large upward swings in CHF/PLN (and EUR/PLN) more likely as compared to downward changes. Therefore although we don't change our FX forecasts we think the risks to our PLN forecasts are asymmetric and skewed towards zloty depreciation.

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