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ESRB
European Systemic Risk Board
European System of Financial Supervision

Assessment of the extension of higher risk weights for exposures secured by mortgages on residential property in accordance with Article 124 of the Capital Requirements Regulation in Poland

Introduction

On 4 August 2023 the Polish Minister of Finance notified the European Systemic Risk Board (ESRB) of her decision to temporarily extend the reduction of the higher risk weights previously set for exposures to a specific property segment secured by mortgages on immovable properties, in accordance with Article 124(2) of the Capital Requirements Regulation (CRR).[1] The Minister of Finance is the designated authority responsible for applying Article 124 of the CRR in Poland. The measure affects exposures where the amount of the principal or interest instalment depends on changes in the exchange rate of one or more foreign currencies different from those in which the borrower receives their income and which are secured by mortgages on residential property (hereinafter referred to as foreign currency mortgages). A higher risk weight of 150% for foreign currency mortgages was introduced by a regulation of the Minister of Finance of 25 May 2017 and had been temporarily reduced for 18 months in March 2022 to a range of 50%-100% for foreign currency mortgages fulfilling certain criteria. The Minister of Finance now intends to extend the period of these lower risk weights by another 24 months. Ultimately, higher risk weights in accordance with Article 124(2) of the CRR should apply for foreign currency mortgages, compared with the 35% risk weight set out in Article 125 of the CRR for these exposures.

Pursuant to Article 124(2) of the CRR, the ESRB is required to provide its opinion on the measure to Poland within one month of receiving the notification. The procedural framework for issuing opinions under Article 124 of the CRR is clarified in Decision ESRB/2015/4.[2]

The ESRB's assessment draws on information provided by, and discussions with, the Ministry of Finance of Poland, Narodowy Bank Polski (NBP) and the Polish Financial Supervision Authority (UKNF).

[1] See Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and amending Regulation (EU) No 648/2012 (OJ L 176, 27.6.2013, p. 1).

[2] Decision of the European Systemic Risk Board of 16 December 2015 on a coordination framework for the notification of national macroprudential policy measures by relevant authorities, the issuing of opinions and recommendations by the ESRB, and repealing Decision ESRB/2014/2 (ESRB/2015/4), as amended by Decision ESRB/2021/7.

1. Description of the proposed measure

The proposed measure consists of an extension to the higher risk weights already applicable for foreign currency mortgages pursuant to Article 124 of the CRR. A higher risk weight for foreign currency mortgages than that set out in Article 125(1) of the CRR was first set at the level of 150% in the regulation of the Minister of Finance of 25 May 2017 and was in force from 2 December 2017. In the regulation of the Minister of Finance of 18 March 2022 amending the regulation of 25 May 2017, the higher risk weight was temporarily reduced for 18 months from the 150% level for certain foreign currency mortgages following the recommendation given by the Polish Financial Stability Committee (FSC), the body responsible for macroprudential supervision in Poland, in September 2021. In accordance with this recommendation and the regulations in force in Poland since March 2022, risk weights for foreign currency mortgages for which banks offer voluntary settlements to clients involving an arbitration court are set for a period of 18 months, ending in September 2023, at three levels: (i) 50% risk weight if loan loss provisions and write-offs or adjustments amount to at least 35% of the gross exposure; (ii) 75% risk weight if loan loss provisions and write-offs or adjustments amount to at least 28% of the gross exposure; (iii) 100% risk weight if loan loss provisions and write-offs or adjustments amount to at least 20% of the gross exposure. It is now proposed to extend this period of reduced risk weights by 24 months. For foreign currency mortgages which do not fulfil the conditions set out in the regulation, the 150% risk weight continues to apply.

The legislative procedure to extend these risk weights is already underway. The recommendation of the FSC was issued to the Minister of Finance on 6 July 2023. The Ministry prepared the proposal for a regulation amending the regulation of 25 May 2017 aimed at extending the term of the risk weight reduction introduced by the regulation of 18 March 2022 by 24 months, and then initiated a legislative process on 18 July 2023. This process requires a public announcement and consultations with the market. When the legislative process is completed and the regulation signed by the Minister of Finance, it will be published in the Journal of Laws of the Republic of Poland.

2. Analysis of the underlying systemic risks

The ESRB identified excessive foreign currency lending as a source of significant systemic risk in its recommendation on lending in foreign currencies in 2011.[3] In this recommendation, the ESRB indicated that excessive foreign currency lending could produce significant systemic risks for the Member States concerned and create conditions for negative cross-border spillover effects. The ESRB therefore recommended taking action on foreign currency lending to: (i) limit exposures to credit and market risks, thus increasing the resilience of the financial system; (ii) control excessive foreign currency credit growth and avoid asset price bubbles; (iii) limit funding and liquidity risks, thus minimising this channel of contagion; (iv) create incentives to improve the risk pricing associated with foreign currency lending; and (v) avoid circumvention of national measures through

[3] Recommendation of the European Systemic Risk Board of 21 September 2011 on lending in foreign currencies (**ESRB/2011/1**).

regulatory arbitrage. The follow-up report to the recommendation[4] in 2015 acknowledged a decrease in the stock of foreign currency lending in Poland following the ESRB recommendation, but still viewed it as high in international comparison. The higher risk weight for foreign currency mortgages introduced in 2017 is in the spirit of the recommendation.

Foreign currency mortgages in Poland continue to pose serious financial stability risks, including legal risks. The Polish banking sector is in the process of dealing with a legacy portfolio of foreign currency mortgages, mainly denominated in Swiss franc. The years 2007-2008 saw a sharp increase in foreign currency mortgages, mainly due to the strength of the Polish currency and the lower interest rates available for foreign currency loans. New foreign currency mortgages were prohibited in 2013, so most of the legacy portfolio was extended before 2009 and has been gradually falling in value ever since. At the end of 2022 the gross value of foreign currency mortgages amounted to roughly PLN 98 billion, equivalent to 3.4% of total assets of the banking sector and 3.2% of GDP (compared with 13% and 10% respectively in 2009). The quality of these loans remains good, yet it is widely recognised by FSC members that foreign currency mortgages generate elevated risks, including legal risk. Following the appreciation of the Swiss franc in January 2015 when the Swiss National Bank discontinued its minimum exchange rate policy of CHF 1.20 to the euro, numerous public initiatives were launched in Poland to forcibly convert foreign currency mortgages into zloty. At the time, FSC members felt a legally forced conversion posed a serious risk to financial stability.

The goals of the original risk weight measure in 2017 were twofold: to ensure resilience and a sufficient level of capital for banks heavily exposed to foreign currency lending, and to provide an economic incentive for banks to voluntarily restructure their portfolios on the basis of individual agreements with borrowers. Implicitly, these actions were also meant to lower the risk of legal initiatives to force conversion into zloty that could jeopardise the stability of the sector. Up to 2020-2021 the number of voluntary agreements was negligible. The situation changed when legal risk began to materialise. Polish courts have regularly invalidated this form of lending, citing consumer protection aspects; for example, the indexation clauses used in foreign currency mortgages were considered abusive. The rulings of the Polish courts led to foreign currency mortgages being overturned and declared invalid, predominantly favouring borrowers. This approach of the Polish courts was in line with the case-law of the European Court of Justice on the interpretation of EU consumer protection laws. In 2019[5] and in 2022[6] it handed down decisions on foreign currency mortgage loans to consumers, finding that the consequences of an agreement's invalidity due to its abusive clauses must be handled according to national law. Not least due to these decisions, the number of claims has increased; more than 127,000 had been filed by the end of June 2023. NBP estimates the overall amount of additional provisions banks need to recognise

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[4] **ESRB Recommendation on lending in foreign currencies (ESRB/2011/1) Follow-up Report – Overall assessment**

[5] Dziubak and Dziubak v Raiffeisen Bank International AG, C-260/18, ECLI:EU:C:2019:819.

[6] E.K. and Others v D.B.P. and Others, joined cases C-80/21 to C-82/21, ECLI:EU:C:2022:646.

at around PLN 50 billion.[7] The Chairman of the UKNF has promoted the idea of voluntary agreements by proposing a common standard for agreements between borrowers and banks. This involves going to the UKNF arbitration court and is intended to convert Swiss franc mortgages into zloty in a way that ensures the situation of a borrower in Swiss franc is equal to that of one in zloty. In other words, a “converted” borrower in Swiss franc should not end up better off than a hypothetical borrower who originally decided to avoid exchange rate risk and took out a loan in zloty instead – even though it was more costly at the time.

The significant involvement of banks in arbitration proceedings to reach settlements with borrowers is particularly important to maintain the stability of the financial system. On 30 June 2023 the portfolio of foreign currency mortgages accounted for approximately 17% of the gross carrying amount (before adjustments) of the entire housing loan portfolio of domestic commercial banks. Significant foreign currency mortgages are also held by the majority of banks recognised as other systemically important institutions. In addition, at that date the value of covered deposits at banks with a portfolio of foreign currency mortgages accounted for approximately 95% of all deposits of commercial banks guaranteed by the Bank Guarantee Fund. The involvement of banks in arbitration proceedings converting foreign currency mortgages to zloty is therefore desirable to limit financial stability risk.

According to the Polish authorities, the aim of the reduced and differentiated risk weights is to address the mismatch in the transition period between recognising provisions and reaching agreements with borrowers, which could have a negative impact on bank capital ratios. As a decision by a bank to enter into a voluntary agreement makes it necessary to recognise upfront provisions for the related costs, this creates a timing and accounting mismatch between the profit and loss impact of these actions and capital requirements. The 150% risk weights would apply as long as the instalments of a mortgage are linked to a foreign exchange rate: in other words, banks can only apply a lower standard risk weight once the loan has actually been converted into zloty. At the same time, banks would have to recognise the costs of reaching settlements (by recognising loan loss provisions, write-offs or value adjustments) when these become probable, in line with accounting rules. In this instance, that would be when the relevant corporate bodies offer borrowers a settlement. As a result, the impact on bank capital ratios could be negative during the transition period between recognising provisions and reaching agreements, which may discourage banks and work against one of the original goals of the FSC recommendation from 2017, which was to facilitate voluntary agreements. Reduced risk weights that depend on the level of provisioning have been in effect since March 2022. They address this mismatch by setting risk weights lower than 150% for banks with significant provisioning that have already decided to offer voluntary agreements with the assistance of an arbitration court, so as to gradually reduce the capital burden on these banks.

As the purpose of the measure was to address the period between the decision to offer agreements and those agreements being reached, its timeframe was intended to be temporary. A time-limited reduction in

[7] *Financial Stability Report*, Narodowy Bank Polski, Warsaw, June 2023, p. 35.

the cost-related risk weight of settlements was intended to encourage banks to agree to such settlements. According to the regulation of 18 March 2022, after a period of 18 months (which seemed sufficient at the time to finalise the settlement programme), the risk weight for foreign currency mortgages would return to the 150% level. Following the UKNF initiative, the number of agreements has increased significantly – but is still lower than the number of court cases. According to data provided by the UKNF, by the end of June 2023 a total of 39,600 settlements had been reached on the lines of the model proposed by the UKNF, and 30,900 on other, individual terms.

In order to continue to encourage banks to offer such settlements, the Polish Minister of Finance proposes extending the temporary reduction of the risk weight by 24 months, on a scale depending on the cost of settlements recognised. This would be in accordance with the recommendation of the FSC of 6 July 2023, which notes that reducing the portfolio of foreign currency mortgages through settlements is beneficial for the stability of banks and the domestic financial system as a whole. The FSC initially thought that 18 months would be enough to reach settlements, but the process has turned out to be more time-consuming. Nevertheless, the measure is still considered to be temporary, and according to the Polish authorities it will not be extended again provided the systemic risk associated with the portfolio decreases sufficiently. This is expected to be the case in two years' time, as the ban on new foreign currency lending, the court rulings and settlements decreasing the size of the portfolio, the increasing provisions to cover these exposures and natural amortisation all point to lower risks in the medium term.

3. Analysis of the effectiveness and appropriateness of the proposed measure

The purpose of the extension of the measure is to mitigate risks to financial stability associated with the legal risk of foreign currency mortgages. Under Article 124(2) of the CRR, the designated authority has to periodically, and at least annually, assess whether the risk weight of 35% for exposures to one or more property segments secured by mortgages on residential property referred to in Article 125 located in the territory of the Member State of the relevant authority is appropriately based on: (a) the loss experience of exposures secured by immovable property; (b) forward-looking immovable property markets developments. The factors are further specified in Commission Delegated Regulation (EU) 2023/206.[8] Where, on the basis of the assessment, the authority concludes that the risk weights set out in Article 125 do not adequately reflect the actual risks related to exposures to one or more property segments fully secured by mortgages on residential property located in the territory of the Member State of the relevant authority, and if it considers that the inadequacy of the risk weights could adversely affect current or future financial stability in its Member State, it may increase the risk weights applicable to those exposures. In the case of the Polish measure, the increased risk weights reflect the fact that

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8 Commission Delegated Regulation (EU) 2023/206 of 5 October 2022 supplementing Regulation (EU) No 575/2013 of the European Parliament and of the Council with regard to regulatory technical standards specifying the types of factors to be considered for the assessment of the appropriateness of risk weights for exposures secured by immovable property and the conditions to be taken into account for the assessment of the appropriateness of minimum loss given default values for exposures secured by immovable property (OJ L 29, 1.2.2023, pp. 1-5).

the standard risk weight of 35% is not felt to be appropriate for foreign currency mortgages based on their loss experience and inherent credit risk, which is notably higher than if they were in domestic currency. Banks also face the risk of losses from settling legal disputes. Given the high share these loans represent in the portfolio, the inadequacy of the risk weight could adversely affect current or future financial stability in Poland. The calibration of the 150% risk weight was supported by a stress test conducted by the UKNF, which included adverse scenarios of exchange rate and housing price shocks.

The ESRB acknowledges that risks, including legal risks, related to foreign currency mortgages pose a threat to financial stability in Poland and supports measures to mitigate these and strengthen banks' resilience. Although the size of the portfolio is gradually decreasing, it is still significant, and the costs associated with settlements and legal agreements may represent a burden for banks that threatens their stability. NBP estimates the additional provisions banks have to recognise at around PLN 50 billion. The ESRB therefore welcomes measures mitigating the legal risks of foreign currency mortgages and building resilience to ensure banks have sufficient capital to cover potential losses on their legacy portfolios of foreign currency mortgages.

The ESRB believes the measure has been effective in incentivising voluntary settlements and mitigating legal risk, although this is still significant. It encourages banks to reach legal settlements with their clients, which in turn reduces legal risks that pose a threat to financial stability in Poland. The mechanism linking the risk weight to the settlement costs recognised was a significant stimulus supporting the process. This is shown by the increase in the number of settlements since the reduced risk weights for exposures involved in settlements were introduced. These activities have made it possible to limit the legal risk related to the foreign currency mortgage portfolio to some extent. However, the ESRB encourages the Polish authorities to assess at least annually whether the measure is contributing significantly to an increase in the voluntary conversion of outstanding foreign currency mortgages into zloty.

The risk weight measure, together with Pillar 2 measures addressing individual institutions, is assessed as appropriate to address the risks of foreign currency mortgages for banks using the standardised approach to calculate risk weights, but the effectiveness and appropriateness of the Pillar 2 measure for those using the internal ratings-based (IRB) approach should be examined further. Risks from the legacy portfolio of foreign currency mortgages are also covered by microprudential Pillar 2 requirements governed by the UKNF. This body has developed a methodology to capture the risks of a foreign currency mortgage portfolio assessed as not sufficiently covered by Pillar 1. It assesses data on how the portfolio behaves in four adverse scenarios and their impact on the LTV ratio, margins, the total capital ratio and the capacity to convert a certain percentage of the portfolio into zloty loans. Based on this assessment, an additional capital requirement is calibrated. It was first deemed necessary to impose add-ons back in 2015. The Pillar 2 measure provides a very targeted approach, which can consider the characteristics of the loan portfolio and contracts of each individual bank. As the risk weight measure pursuant to Article 124 of the CRR can only target banks using the standardised approach to calculate the risk weights of their mortgage loans, the Pillar 2 requirements are also used to mimic these for banks using the IRB approach and create incentives for settlements. Banks using IRB in Poland can be eligible for the reduced capital requirement through the Pillar 2 measure if they offer settlements that meet the UKNF conversion proposal. This raises the question of whether incentives for IRB banks are as effective as those for banks using the standardised approach.

Alternative measures might not be as suitable or effective in addressing the risk at hand as those under Article 124(2) of the CRR. Nevertheless, the ESRB still encourages the Polish authorities to continue to assess the possibility of introducing other macroprudential measures to address systemic risk. The Polish authorities take the view that targeting the risk from foreign currency mortgages with a sectoral systemic risk buffer (sSyRB) would be less suitable. As the Pillar 2 measure is tailored to each bank and institutions are already familiar with the methodology, the Polish authorities decided not to pursue other possibilities, including an sSyRB (which was not available when the Pillar 2 measure was introduced). Unlike the Pillar 2 measure, an sSyRB cannot address the risks on foreign currency mortgages already repaid – which are also still a source of legal risk. Even so, the ESRB still sees merit in continuously assessing the possibility of introducing an sSyRB; compared with the Article 124 risk weight measure it could provide a more flexible option to address the risk at hand, and could be applied to banks using both the standardised and the IRB approach. As for an alternative measure for IRB banks, the Polish authorities considered setting a higher minimum LGD value pursuant to Article 164 of the CRR in 2017, when the 150% risk weight was introduced for banks using the standardised approach. However, they deemed it too difficult to apply, as it only has an indirect effect on the risk weight of the exposure and the risks related to foreign currency mortgages show up also through materially higher PD values. It is worth noting that the danger of inadequate risk weights may be lower for IRB banks; while the standardised approach could be insufficiently granular to reflect the elevated credit risk on these mortgages, banks using the IRB approach might have more scope to differentiate between the risk weights of domestic and foreign currency loans. However, given that the Polish authorities aim to address systemic risk, and depending on their assessment of IRB models, it may be appropriate to activate a designated macroprudential instrument for IRB banks as well. The ESRB sees merit in assessing the adequacy of IRB risk weights for foreign currency mortgages and, if these are deemed inadequate and giving rise to systemic risk, consider introducing a risk weight measure under Article 458 of the CRR for banks using the IRB approach. This could also be used to incentivise them to offer voluntary settlements, similar to the measure pursuant to Article 124 of the CRR for banks using the standardised approach.

Conclusions

The ESRB acknowledges the systemic risks related to foreign currency mortgages and welcomes measures to address them. Therefore, it does not object to the proposed Polish measure pursuant to Article 124 of the CRR. The Polish authorities should ensure that enough capital is available to cover potential losses due to the legacy portfolio of foreign currency mortgages. Apart from, or in addition to, the proposed risk weight measure pursuant to Article 124 of the CRR, the possibility of introducing, for example, a sectoral SyRB or a risk weight measure pursuant to Article 458 of the CRR for IRB banks should be kept continuously under review. As for the aim of converting outstanding foreign currency loans secured by mortgages on residential property into loans denominated in zloty, the national authorities of Poland should also take into consideration a broader set of potential measures to set additional incentives for voluntary agreements to do so.

Under the current circumstances, the adjusted levels of the risk weights and the duration of the measure are assessed as appropriate and effective in addressing the identified risks. The extension of the measure adjusting the elevated risk weights applicable in Poland to foreign currency mortgage exposures by the Polish Minister of Finance will lead to no substantial change in the overall outlook on financial stability in relation to the residential real estate sector in Poland. Under the current circumstances, the measure does not entail disproportionate adverse effects on financial stability in Poland nor is it expected to form or create an obstacle to the proper functioning of the internal market. In addition, the measure is assessed as being in line with the ESRB's view on foreign currency lending as expressed in Recommendation ESRB/2011/1.

The ESRB encourages the Polish Minister of Finance to monitor and periodically reassess the situation and adjust the risk weights depending on the change in systemic risks. The ESRB recalls that the Polish Minister of Finance is obliged under Article 124(2) of the CRR to assess periodically, and at least annually, the appropriateness of the risk weights set out in Article 125 of the CRR. If these do not adequately reflect the actual risks related to the exposures and if it is considered that their inadequacy could adversely affect current or future financial stability in Poland, the designated authority should consider adjusting them accordingly. This applies in particular to the risk weights set for foreign currency mortgages, which were increased in 2017. The materiality of foreign currency mortgages is expected to decline over time, partly as a result of their conversion into zloty. If the size of the remaining exposures is contained, the rationale for maintaining higher risk weights than 35% on macroprudential grounds will be weakened.