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ECONOMIC CONSEQUENCES OF THE CJEU'S RULING ON LOANS INDEXED TO SWISS FRANCS IF IT IS CONSISTENT WITH THE OPINION OF THE ADVOCATE GENERAL

COMMENTARIES BY ECONOMISTS ON THE OPINION OF THE ADVOCATE GENERAL OF THE COURT OF JUSTICE OF THE EUROPEAN UNION IN CASE C 260/18 DZIUBAK

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PREFACE

Discussion on the expected judgment of the Court of Justice of the European Union in the famous "Swiss Franc" case (ref. C-260/18) in the Polish media space was dominated by law firms representing Swiss franc borrowers. The extremely intensive presence of advocates and legal advisers in the media is fully understandable. The opinion of the Advocate General of the CJEU issued in the "Swiss franc" case gives hope to thousands of borrowers concerning favorable judgments in their disputes with banks.
However, each and every borrower who decides to litigate must first select a lawyer. This is why the powerful media offensive of a portion of the industry is based on fueling these hopes.

The "Swiss franc" lawyers attempt to build the conviction that the whole issue is simple and clear. But the reality is completely different. The world of economics can see numerous controversies and threats in the forthcoming CJEU judgment. We should be aware that if the Court shares the opinion of the Advocate General in its final judgment, it may soon begin to shape Polish case law and consequently the state of the Polish financial market.

The Jagiellonian Institute has been following the situation of loans indexed to and denominated in the Swiss franc for over four years, ever since the infamous "Black Thursday" in 2015 when the Swiss franc price shot up, increasing significantly the indebtedness and the monthly installments paid by thousands of Polish mortgage borrowers. We are analyzing this matter with a cool head and with no unnecessary emotions, focusing mainly on the political and economic aspects. This is how we perceived our role when we (together with Kantar Public) conducted a survey of the election preferences of Swiss franc borrowers and the public perception of the legal solutions proposed at that time. This is also how we perceive it today as we publish the opinions of economists analyzing the expected judgment of the CJEU and its consequences in the context of their invaluable knowledge and broad experience.

Accordingly, this publication has been written as a voice to balance the narrative of law firms as mentioned above, which focuses on the short-term interest of potential clients, while neglecting the long-term consequences for the economy and all consumers. Without questioning the competence of lawyers or denying anyone the right to present their views on a "Swiss franc" case pending before the CJEU, we would like to provide the readers with a brief summary of the economic aspects and possible consequences of the Court's judgment.

We are aware that it is difficult to remain indifferent to some of the strong comments included in our report. Our intention, however, is to provoke a constructive discussion on the merits of the case. We hope that it will contribute to the development of national case law that will be beneficial to current and future market players.

Marcin Roszkowski
President of the Jagiellonian Institute

CONCLUSIONS

Possible consequences of approving the "PLN + LIBOR" mechanism by the Court of Justice of the European Union:

- **Separating a currency from its inherent interest rate, which is artificial and incompatible with the laws of economics** – the court decrees a market anomaly unpredictable macroeconomic consequences

- **Creation of a new financial instrument with unknown risks** – disruption of economic processes and disruption of the notion of value of a currency, which underlies financial stability of the state

- **Violation of two EU regulations: Benchmarks Regulation of the European Parliament and the EU Council (BMR) and a decision of the European Securities and Markets Authority (ESMA) authorizing the administration of LIBOR** – those documents do not permit any index to be applied to any currency

- **Establishment of a *de facto* new currency with the Polish monetary unit and a Swiss interest rate ("Swiss zloty")** - loans in the new currency will not be subject to monetary decisions of the National Bank of Poland

- **Unequal treatment of consumers** – the PLN borrowers will have to repay much more expensive loans than the Swiss franc borrowers, who had benefited from favorable exchange rates and low interest rates for many years. Their preferential treatment was a bonus received for taking risky economic decisions.

- **Transfer of costs of individual FX risk from Swiss franc borrowers to the entire banking system**, and consequently to other borrowers and market players

- **Incentive for moral hazard** – protecting consumers from conscious economic risk-taking does not protect them against similar crises in the future

INTRODUCTION

On 14 May 2019, Giovanni Pitruzzelli, Advocate General at the Court of Justice of the European Union, responding to questions from the District Court in Warsaw, issued an opinion in the case of Dziubak vs. Bank Raiffeisen, ref. no. C260/18.

In 2008, Mr. and Mrs. Dziubak took out a mortgage loan indexed to the Swiss franc. The rules of indexation were set out in the rules and regulations accompanying the loan agreement. The Bank calculated the balance of debt and installments on the basis of the exchange rate specified in an internal table, that is based on a FX rate difference clause. Several years later, the borrowers sued the bank requesting invalidation of the loan agreement. In their opinion, the bank used a prohibited (abusive) provision, which allowed it to unilaterally and at its discretion set the Swiss franc exchange rate and therefore also the installment amounts.

In April 2018, Judge Kamil Gołaszewski hearing this case referred several questions to the Court of Justice of the European Union for a preliminary ruling. He had doubts, among other things, whether it was admissible to fill in the "gaps" in the agreement after the parts deemed forbidden are removed.

The opinion of the Advocate General of the CJEU is a kind of prelude to the final judgment of the Court expected in the coming weeks. The Advocate General wrote, among other things, that if the foreign exchange difference clause is ruled to be unfair, the court has no right to change that clause and accordingly it should be removed from the agreement.

In practice, this means that "if the term regarding 'exchange difference' were unfair and, therefore, did not apply, that would have the effect of transforming the type of the contract from one indexed to CHF and subject to the interest rate of that currency, to one indexed to PLN but still subject to the lower interest rate of the CHF". (paragraph 41 of the Advocate's opinion).

On the one hand, the unprecedented concept of "PLN + LIBOR" aroused enthusiasm amount Swiss franc borrowers (it gives them hope for the conversion of loans at the exchange rate on the day they were taken out and for exceptionally favorable interest rates due to the low, now even negative, LIBOR CHF interest rate), while on the other hand, it raised serious concern among economists who fear for the stability of the financial system and the Polish currency, and see it as a dangerous precedent. The CJEU ruling, if consistent with the opinion of the Advocate, will introduce a financial product to the market, which *de facto* does not exist and could never be offered.

1. "MORAL HAZARD" AND PUNISHMENT OF PLN BORROWERS

Prof. Elżbieta Mączyńska PhD Hab *– President of the Polish Economic Society, lecturer at the Warsaw School of Economics*

The Advocate General's Opinion in Case C 260/18 and its conclusions are, by their very nature, asymmetrical, which means they do not consider the interests of both sides of the dispute. The CJEU Advocate General explicitly states that "the system of protection [of the Court of Justice of the EU] is based on the idea that the consumer is in a weak position vis-à-vis the seller or supplier" and therefore it is aimed at "restoring the balance between the position of the consumer and that of the seller or supplier". In my opinion, this means ruling in advance in favor of an individual borrower, with no regard for the consequences it will have for the general public, including other borrowers.

PLN borrowers will be able to conclude that they have been treated unfairly and even penalized as a result of the asymmetric preference granted to Swiss franc borrowers. The Advocate General refers several times to the Consumer Protection Directive, which states that regardless of the economic consequences, the protection afforded to the consumer must be particularly strong and the infringing party must be properly punished. When punishing banks, can innocent people who are not directly involved in the franc case be punished at the same time? I have the impression that the intention of the CJEU is, first and foremost, to impose a penalty on the party considered to be unfair. In this case, however, this "punishment" may ultimately also affect other market participants, not only banks, which may adversely affect the entire economy.

The opinion of the CJEU Advocate General is an incentive to embrace "moral hazard". The case law in favor of franchisees may trigger an avalanche of lawsuits on the part of PLN borrowers and others, who may feel treated unequally.

And when the PLN interest rate increases then the level of frustration among PLN borrowers would become even stronger. This could lead to a new wave of lawsuits and a vicious circle of claims.

2. DECREEING AN ECONOMIC ANOMALY

Tomasz Mironczuk *– president of the Financial Market Institute, expert on financial instruments and interest rates*

TSU shows utter disregard for the laws of economics, which are not dependent on court decisions. This can be compared to an attempt to decree that the law of gravity is no longer in effect. The court could, of course, pass such a judgment, but it would have no impact on the laws of physics.

When taking out an indexed or denominated loan in 2008, a client took on two risks: the CHF to PLN foreign exchange rate risk and the Swiss franc interest rate risk. Both risks are inherently interrelated. Today, it is considered abusive that no one has informed the borrower how the PLN to CHF exchange rate would be determined as the installments are repaid. The Client claims that currency risk was estimated at an exchange rate defined by the bank at its discretion. However, **the provisions forcing banks to specify the exact method of calculating the exchange rate have only been in effect since 1 January 2018** in the form of the Benchmarks Regulation.

The Advocate General disregards the fact that currency risk does not exist in isolation from interest rate risk. This can be compared to remuneration for the work of a judge, which can last the same number of hours in a 24-hour period as the work of a construction worker, but has a completely

different price. For the price of work depends on its character rather than just the period of time in which it is performed. The same applies to different currencies. **The price of money has two inseparable dimensions: one of them is the interest rate, while the other is the exchange rate. The CJEU wants to separate them by force.**

3. TRANSFERRING THE COST OF RISK TO THE SYSTEM.

Andrzej Reich *– former Director of the Banking, Payment Institutions and Credit Unions Licensing Department at the Office of the Polish Financial Supervision Authority (2012-2018) and a management board member of the European Banking Authority (2013-2018).*

Both the lawsuit and the CJEU Advocate's opinion challenge the mechanism used to calculate the interest rate by the bank, claiming that it was arbitrary. One must remember, however, that every bank sets its own exchange rate table. If this fact makes it unfair then where should the banks get market exchange rates? If the Advocate challenges the right of a bank to set an exchange rate for a Swiss franc independently then it actually targets its allegation against the whole exchange rate table. Was it his intention to challenge all currency operations carried out by banks? If someone sent me a transfer of 100 Swiss francs to my PLN account then my bank would convert these 100 Swiss francs into Polish zlotys using the exchange rate table. Would the opinion of the Advocate General give me the right to challenge the amount received in Polish zlotys, for example as insufficient, because it was calculated on the basis of an exchange rate set by the bank? Naturally, I can understand that in the case of foreign currency loans, pathologies may have occurred, but the statement of claim and the Adocate's opinion refer to the principle and not the pathology.

In 2008, the Banking Supervision Commission issued recommendation S, in which it clearly wrote about the risk connected with FX loans and what a consumer should know when concluding agreements of this type. **We were concerned whether the borrowers knew the risks associated with foreign currency loans** (after the recommendation S came into force, they made a written declaration that they were familiar with and accepted the risks).

After Recommendation S was issued, a huge demonstration was held in front of the National Bank of Poland under the slogan "WE WANT OUR RIGHT TO RISK". A terrible row arose and the regulator was accused of trying to deprive the poorer Poles of the right to cheap credit. **We should remember this today when the Swiss franc borrowers complain that something was concealed from them**.

There is a passage in the opinion of the CJEU Advocate General, in the part describing the facts of the case: " In the alternative, the borrowers requested that the contract be performed without the unfair terms, on the basis of the loan amount stipulated in Polish currency and the interest rate stipulated in the contract, based on the variable LIBOR and the bank's fixed margin". Challenging the independent definition of an exchange rate table by a bank, coupled with the request to keep the LIBOR rate in PLN contracts indicates that the currency risk mechanism is well understood. **Clearly, an attempt has been made here to transfer the costs of FX risk from borrowers to the whole banking system.**

4. CREATION OF A DANGEROUS FINANCIAL INSTRUMENT

Tomasz Mironczuk

The CJEU is trying to decree a new, previously unknown financial instrument, a "hermaphrodite" of sorts: a PLN loan bearing interest at the LIBOR rate for the Swiss franc. If Polish judges start copying this ruling en masse then the instrument may be created on a mass scale. No-one knows how to manage such a financial instrument. Additionally, the CJEU's ruling that CHF LIBOR should be used may raise another problem when LIBOR suddenly cannot be used, for example when it ceases to exist or becomes incompatible with the new regulations on indices. For two years now, the discussion about how long LIBOR will survive has been one of the most important issues for the future of financial markets.

5. CREATION OF A NEW CURRENCY – "SWISS ZLOTY"?

Andrzej Reich

If the Court rules in line with the CJEU Advocate General's opinion, a loan agreement indexed to the Swiss franc would be even more unenforceable than the current one. LIBOR is an indicator determined on the London market for several major currencies. PLN is not among them, because PLN LIBOR just does not exist.

If the Court upholds the Advocate General's opinion, it will create a new currency, which would bear the name and value of the Polish zloty, but would bear interest at the CHF LIBOR rate. **It would be neither Polish zloty nor the Swiss franc. It would be a "Swiss zloty" existing in the territory of Poland but subject to monetary decisions of the Swiss central bank.**

6. UNDERMINING FINANCIAL STABILITY

Tomasz Mironczuk

The consequences of the CJEU judgment for the economy and the financial market will be enormous, irrespective of how much the final costs will be, PLN 60 billion or "only" PLN 20 billion.

The banks will post losses, while clients will achieve gains on account of foreign exchange risk and interest rate risk of the Swiss franc, despite the fact that in the past customers and banks agreed on a different allocation of risk. This will affect the entire market and all consumers, and above all **will undermine the notion of the value of the currency, on which the state's financial stability is based**.

If at least one of the banks is threatened with insolvency, the Bank Guarantee Fund has just PLN 16 billion, so it will have to charge the remaining banks with an extraordinary contribution. This may cause a domino effect.

Banks will not be able to carry the burden of the judgment and further charges for the Bank Guarantee Fund. We should also remember that the price of shares of banks listed on the WSE will be declining at the same time.

7. VIOLATION OF EU LAW

Andrzej Reich

If the final judgment of the CJEU repeats the conclusions of the opinion of the Advocate General, it will have serious consequences for the entire EU market. The CJEU judgment would lead to non-compliance with EU law.

Firstly, the EU BMR emphasizing the need to use interest rates corresponding to the currency would be violated.

Secondly, the CJEU judgment would stand in contradiction with the decision of the European Securities and Markets Authority (ESMA) permitting the administration of the LIBOR, which states that index (interest rate) should not be applied to a currency other than the one for which it was issued.

If the Court upheld the Advocate General's opinion, it would thereby rule that any index could be applied to any currency. This would be a dangerous precedent. In particular, banks in the EU would be able to grant loans bearing interest at other, higher interest rates.

Elżbieta Mączyńska

The minimum that could be expected of the CJEU is to observe the European regulations. The CJEU opinion is not fully consistent with other EU regulations, all the while the CJEU is also an EU institution that is to guard these rights. **This situation is somewhat schizophrenic.**

8. LACK OF ECONOMIC EDUCATION OF JUDGES

Elżbieta Mączyńska

The opinion of the CJEU Advocate General indicates that the final decisions will be made by national courts and this is where **we face the challenge of educating judges on economics**. The need to educate the legal community, mainly judges, about economics, is becoming a fundamental and increasingly urgent issue.

A few years ago, the Warsaw School of Economics held postgraduate studies for judges and prosecutors. In the surveys carried out at that time, **judges and prosecutors admitted to the considerable economic ignorance.** Why is this happening? Because the curricula of the law faculties clearly lack space for economic topics and there is no educational profile focused on the economic aspects of law. For example, according to my doctoral student, students at the University of Warsaw were offered only 30 hours of lectures on bankruptcy law, and only as an option. one of the negative consequences of the judges' lack of economic knowledge is that they choose to **apply the letter of the law, without respecting its spirit**.

The opinion of the CJEU Advocate General, as well as many previous judgments of Polish courts in Swiss franc cases, are an excellent example how the spirit of the law may be disregarded when certain regulations or contract clauses are taken literally. This trend would be dangerous for the economy, because it would leads to economically absurd outcomes.

PARTICIPANTS IN THE DEBATE:

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