

BETWEEN MARKET AND REGULATORS , CHANGES IN BANKING REGULATION ON EXAMPLE OF MORTGAGE IN POLAND

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Abstract in original language

Zmiany jakie zaszły w sytuacji ekonomicznej Polski oraz niedawny kryzys finansowy spowodowały, że ustawodawcy, nadzór finansowy oraz banki wspólnie podjęli próbę unowocześnienia instytucji hipoteki. Każdym z nich kierowały inne cele i powody: poczynając od zwiększenia stabilności i bezpieczeństwa rynku finansowego, wzmocnienia bezpieczeństwa klientów banków, aż po zwiększenie atrakcyjności usług kredytowych. Efektem tych prac było niemal równoczesne stworzenie następujących aktów: nowelizacji Ustawy o księgach wieczystych i hipotece dokonanej przez Parlament, Rekomendacji S i Rekomendacji T będących wynikiem prac Komisji Nadzoru Finansowego, a po stronie sektora bankowego wprowadzanie przez poszczególne instytucje własnych regulacji wewnętrznych. Celem tego artykułu jest zbadanie w jakim stopniu te różne cele i powody znalazły odbicie w nowych regulacjach, oraz w jakim stopniu wprowadzone zmiany odpowiadają wymogom rynku oraz procesu harmonizacji prawa wspólnotowego.

Key words in original language

Hipoteka, regulacje, nadzór, dyrektywy, harmonizacja

Abstract

Recently in Poland took place a re-construction of the legal framework for mortgages. Almost simultaneously the Parliament Almost simultaneously the Parliament created amendment to the Mortgage Act, the Commission of Financial Supervision (KNF), which is the state financial regulator, introduced the Recommendation S and an amendment to the Recommendation T, while banks started to implement some new internal regulations. They all had different reasons to start such work, the aim of this article is to analyze how different approaches and aims of those bodies have been reflected in the process of the enactment, and to what extent these new regulations match the demands of the market and the process of the harmonization of the EU's legal system. To avoid ambiguities, just for practical purpose in this paper the term *mortgage* will be used as an equivalent of the term *hypothec*, despite existing between them linguistic and juridical differences.

Key words

mortgage, legislation, regulator, directives, bank supervision, harmonization

Mortgage in Poland

In Poland the legal base for mortgage is the Mortgage Act from 1982, therefore due to a noticeable social and economic development which took place in years that passed from that date an adjustment of that regulation to demands of modern market became a crucial matter. Another impulse towards such legislative changes arose from Poland's accession to the European Union in 2004 which coincided with a series of the Commission's initiatives aimed at tackling the barriers to further integration of financial markets.

Modern Poland for years has been trying to solve the problem of structural deficit of dwellings, as according to various sources it troubles from 1,4 up to 2 million of families.¹ Therefore, seeing in a mortgage a remedy and knowing that its popularity, although growing in recent years, still is very low (according to the data provided by the Union of Polish Banks, till the end of year 2010 the total sum of granted by Polish banks mortgage credits reached only 10% of Poland's GDP, while for instance in the USA that ratio reaches 80%)², the Polish Parliament decided to take some steps in order to improve that situation.

The main aim of the legislator was to create collateral which at the same time is very effective and flexible, but also more affordable and thanks to that more popular. How difficult goal it was shows the fact that implemented on 20th of February 2011 amendment was created on basis of three different versions of that act, prepared by separately working groups of legislators. Its final version, beside reshaping some incoherent regulations, introduced some significant changes leading to simplifying the procedure. Still, the new regulation preserves mostly in unchanged form the character of that institution even though Poland has been participating in the works of the Eurohypotheq Research Group and the EU's Government Expert Group on Mortgage Credit where discussed have been some revolutionary changes to a mortgage (for details see Nasarre-Aznar).³

¹ Nierodka A., „Mortgage Climate” (Report no 3, 2010), March 26, 2011, www.ehipoteka.pl

² Report Amron Sarfin, March 26, 2011, http://zbp.pl/photo/!Struktura/Raporty/AMRON-SARFiN/Raport%20AMRON_SARFiN_4.pdf

³ Nassarre Aznar S., „Looking for a model for a Eurohypotheq, March 26, 2011, www.ehipoteka.pl

That so well known from the civil law system rule saying that a mortgage can secure only monetary obligations remained (art68.1 of the Act)⁴, while as the process of the unification has not yet included that institution, those introduced recently changes can be only classified as *lex rei sitae* rules.⁵

One of the most important of them is the annulment of the division between a mortgage collateral securing only the principle (called *mortgage for a fixed amount – hipoteka zwykła*) and the one which was securing interests or some uncertain future sum registered as valid up to some given amount (called *cap mortgage - hipoteka kaucyjna*). The legislator has now decided that just that last one is sufficient and effective enough both for borrowers and lenders. Benefits of such solution are: much simplified registration procedure, an enhanced flexibility of that collateral, and lowered cost of encumbering, as a mortgagor has now to pay just for registering one mortgage instead of two of them, to secure a credit/ loan contract.

Practical reasons made the legislator also decide to introduce to the Polish legal system some solutions which had their origin in many lasting already for years pan-European consultations and discussions on the shape of universal for all the EU's members institution of a mortgage. The Polish lawmakers chose to initiate such changes in hope they should have some positive influence on the Polish mortgage market.⁶ Therefore one of those new regulations says that now by just one mortgage secured can be more than one loan or credit agreement (art 68.1 of the Act), already existing or a future one, if the beneficiary is the same, or even if there are various mortgagees but on condition they provided funds for the same undertaking.

Another regulation allows the owner of an estate encumbered with more than one mortgage, to decide in case one of those secured with mortgages loans or credit agreements expires, if he wants to change the ranking of all of them, or if he wants to grant one of them a priority. Such solution made possible a situation where in exchange for a better position in the mortgage ranking mortgagor can receive some benefit i.e.: banks can offer him better conditions and interest rates.⁷

The new amendment offered one more right to the mortgagors, as now if the amount in the mortgage registration exceeds the real amount of encumbrance, they may ask the court to lift up the mortgage to match that real mortgage debt. The practical effect of such change for mortgagors is that once it is done their credibility scoring will be improved.

⁴ Ustawa o księgach wieczystych i hipotece, Dziennik Ustaw, 2001 No 124.1361

⁵ Pisuliński J. (Ed), „Hipoteka po nowelizacji, Komentarz, Warszawa, LexisNexis, 2010

⁶ Gniewek E., „Współczesne modele hipoteki”, Monitor Prawniczy, 2011, no 4

⁷ Siwek A., „Hipoteka – nowe uprawnienie dla właściciela nieruchomości obciążonej, March 05, 2011, www.nieruchomosci.beck.pl

While those changes can have real impact on the situation on the Polish mortgage market, as the works on the unification of European legal systems regulating mortgage did not pass the consultation level, the compliance of that amendment with the EU's regulation cannot be assessed.

The new Recommendations

Severe financial turmoil which has shaken financial markets, first in 2007 and once again, that time with even stronger force in 2008, revealed how insufficient was the regulation and supervision of financial institutions, both at the national and the international levels, and how ineffective was the international cooperation of supervisors (see the Report of the High Level Group on Financial Supervision in the EU - Larosiere Group).⁸

The financial safety net became a topic of world-wide discussion. The problem which has arisen was the question to what extent legal requirements are able to induce an adequate risk taking and risk transfer on financial markets, preventing at the same time an excessive risk taking, as essential part of banking is dealing with financial risk and as such - cannot be avoided.⁹ Such regulations have to on one hand allow competition while on the other hand they have to prevent systemic risk, at the same time they also should create such a situation where the participants of the financial services market will be able to have confidence in financial institutions. Therefore another public international consultation was launched, to find legal tools to ensue investor protection, which is now regarded as one of the most significant responsibilities of financial services. As a result international financial supervisory institutions and the European Commission already issued a series of systemic regulations, while they still have some other under discussion or approval. The remedy to regain and maintain bank soundness was already earlier provided in the form of the Basel Core Principles for Effective Supervision and the EU Directive on Credit Institutions (Directive 2006/28/EC), therefore the public consultations launched by the European Commission this time have focused mainly on safety and quality of consumer credit. The effect of that cross-European discussion came in a form of new "Directive on Credit

⁸ Report of the High Level Group on Financial Supervision in the EU, 2009, March 26, 2011,

http://ec.europa.eu/internal_market/finances/docs/de_larosiere_report_en.pdf

⁹ Ohler C., „International Regulation and Supervision of Financial Markets after the Crisis”, Working Papers on Global Financial Markets, No 4, 2009, <http://www.gfinm.de/images/stories/workingpaper4.pdf>

Agreements for Consumers”¹⁰ and already launched consultations on “Responsible Lending and Borrowing in the EU”.

Although those legal acts can be seen mainly as guidelines of good banking practice, awareness of challenges which banks have been facing from the start of the crisis resulted with some special steps taken individually by them, some of them out of their own initiative, some as the result of heavy regulatory pressure of national supervisory financial authorities, which also created some of safety rules on their own, that mainly took form of tightening of credit standards for loans.

Poland, being geographically and politically placed in the centre of that financial storm, re-emerged from it almost unscathed, but the evidence which that economic crises provided has had its direct implications on Polish banking regulations, as local authorities took that lesson seriously. Some new rules and procedures were implemented, among them those which recently caused some public stir and discussion, as they have direct impact on life and financial situation of many Poles, due to the fact that mortgage credits and loans became popular remedy for still high deficit of dwellings, while their availability and conditions of repayment may now become even harder to meet, when compared to previous prudential procedures.

The Polish banking system was not badly experienced by the crisis, especially as some banks reacted instantly to the situation by tightening their security policy, nonetheless the national financial regulator – the Commission of Financial Supervision (Komisja Nadzoru Finansowego) has recognized some potential dangers within Polish banking system. In the introduction to the newly implemented into the Polish banking legal system Recommendation T the KNF named some of them: lowering requirements in credit analysis, excess elongation of amortization schedules of loans in order to offer to borrowers lower monthly payments and acceptance of enlarged LtV (loan-to-value) ratio.¹¹ All of them, in opinion of the KNF arose from existing in Poland tough competition between financial services institutions. These failings in process of risk management as well as present situation on the global financial market, led the KNF to the decision that to protect the banking system some regulations have to be changed.

The KNF, when public consultations on new regulations were launched, put a great stress on that truth that recent financial crisis has provided a perfect proof of how tightly the world we are living in is correlated and how illusionary are each country’s physical borders, when threatened by such

¹⁰ Directive 2008/4/EC on Credit Agreement for Consumers

¹¹ Komisja Nadzoru Finansowego, „Rekomendacja T”, 2010, March 20, 2011, <http://www.knf.gov.pl/regulacje/praktyka/rekomendacje/rekomendacje.html>

global jeopardy. The regulator emphasised that the globalisation is a fact, especially in the field of finance, with so many examples coming from various parts of the globe proving how necessary is the process of maximal harmonization of cautionary measures which countries would be able to apply to protect their financial markets.¹² Therefore both new recommendations, beside providing methods and solutions which are supposed to protect the Polish banking system, are at the same time tools with which the KNF is trying to reshape the framework of banking system in Poland to achieve its compliance with the EU regulations.

These two recommendations took the form of two sets of principles of good banking practices – one is called the Recommendation S and relates to mortgage risk exposures,¹³ the other one is called the Recommendation T and regulates retail credit risk exposures.

Although these documents are not universally binding legal acts, still, as they are issued on the basis of specific authorisation contained in the Polish Banking Law (art. 137.5)¹⁴ together with art 11 of the Act on Supervision of Financial Market,¹⁵ and as they are addressed to Polish banks, they have binding power over them, as institutions subordinate to issuer of these acts. The Recommendation S was issued in 2008, but already have been amended in 2011, while the Recommendation T is from February 2010 and has been introduced into banking practice at the end of year 2010.

The Recommendation S is addressing such fields as: general management, risk management, exchange rate risk and interest rates' risk to which the borrower is exposed, collateral and customer relationship, while the Recommendation T is dealing with general management, risk management, also with the identification, measurement and the problem of setting the limits of acceptable risk, collaterals and customer relationship and internal controlling, and they are supposed to act as a framework for good risk management, controlling and integration of all banking procedures involved in the process of offering loans and mortgages. As was already mentioned earlier in both of them we can recognize large influence of some of the EU latest directives regulating financial services.

Studying the texts of both Recommendations leads to the conclusion that just like in the Directive 2008/48/EC on Credit Agreement for Consumers, special attention is paid there to customer protection against unfair and

¹² *ibidem*

¹³ Komisja Nadzoru Finansowego, „Rekomendacja S”, 2011, March 20, 2011, <http://www.knf.gov.pl/regulacje/praktyka/rekomendacje/rekomendacje.html>

¹⁴ Prawo bankowe, Dziennik Ustaw, 2002, no 72.665

¹⁵ Ustawa o nadzorze nad rynkiem finansowym, Dziennik Ustaw, 2006, no 157.1119

misleading practices. Both recommendations make banks obliged to act with professional diligence to enable their customers to make their decisions in full knowledge of the facts by offering to them clear, complete and adequate information, enabling them to decide whether the credit product they are being offered is suitable for them, already when it is just advertising and marketing, then stage prior to the conclusion of the credit agreement, and later during all phases of the credit relationship. That information should include: the borrowing rate, any index or reference rate applicable to initial borrowing rate, the charges applicable from the time the credit agreement is concluded, the amortisation table with the amount and frequency of payments, while such table - in case of loans where the interest rate is not fixed – should clearly indicate that the data contained there can be changed in accordance to conditions included in the credit agreement.

Both recommendations make banks obliged to implement special procedures of providing customers with any information that may have an impact on the cost of that credit and involved with it risk, such as exchange rate. Special emphasis is put on binding banks not to recommend loans in other currency than the one in which the borrower is receiving his or her income as they make customers more exposed to risk.

Separate problem which appears in those two Recommendations is the task of providing an advice. In distinction from providing information which is just description of the product, advice comes closer to recommendation, and here both those regulations implement the same solution as the one which can be found in mentioned earlier the EU regulations, that such advice cannot put undue pressure on the borrower. Therefore it has to be provided by specially trained bank specialist, and should be objective, matching the needs of the borrower, and offering explanation of types of risks involved in that product. Here the Recommendation S follows what appeared in the 2007 White Paper on the Integration of EU Mortgage Credit Markets.¹⁶ Another example of a solution appearing in the Customer Credit Directive which was also incorporated into both of these recommendations is the one ordering banks to assess the customer's creditworthiness on the basis of sufficient information, obtained from the customer and through a consultation of the relevant database.

With the problem of monitoring customers' creditworthiness connected is monitoring of accepted collateral. Both recommendations ordered banks to develop and use special polices, procedures, controls and tools which should enable them to monitor the value of real estate when the mortgage was given, and any other security which was accepted by the bank in case of other type of credit product.

¹⁶ European Commission, „White Paper on the Integration of EU Mortgage Credit Markets, www.ec.europa.eu/internal_market/finances-retail/home-loans/integration_en.htm#whitepaper

After witnessing the broad run for mortgage loans and the sharp end of the boom in housing prices in the USA, the KNF made some regulations of the Recommendation S even more strict than Directive 2006/48/EC, for instance those relating to the taking up and pursuit of the business of credit institutions, providing the framework for supervision of banks' soundness and as such also suggesting methods of risk monitoring. When the Directive states that the value of the property should be monitored on the frequent basis, at a minimum once every three year for residential real estate, the Recommendation orders banks to do that at least once every year.

Special attention is paid by the KNF to technical side of the process and the control of risk monitoring, as both Recommendations demand an implementation of special management systems, procedures, and control functions offering accuracy, completeness and appropriateness of model inputs and results, which effectiveness has to be constantly reviewed to limit potential errors.

Beside those general rules making the regulation of the Polish banking system more harmonized with the works of the European Committee, the KNF introduced a group of detailed regulations setting some national limits and processes binding all Polish banks.

Reaction of the Banking Sector

Despite the fact that the Recommendations set only the framework of regulations which Polish banks should fill with their own solutions, those solutions implemented there by the KNF were fiercely criticised by the Union of Polish Banks. There were many arguments used (see the KNF response to them titled: Myths concerning the Recommendation T)¹⁷, some of them were predicting very dramatic impact of the KNF actions, including such that the number of granted loans and credits may drop by 80%, making people stop buying goods what will lead to a general economic stagnation. The KNF also was accused of unfair treatment of the poorer group of the society by allowing them to use loans and credits only to very limited extend, due to the limit which was introduced by the Recommendation T, making possible granting loans and credits only if the monthly instalments were not bigger than half of the borrowers' income. In that discussion became involved also the media, representing the customers, who were

¹⁷ „Mity związane z Rekomendacją T” (n.d), March 04, 2010, March 26, 2011,
http://www.knf.gov.pl/aktualnosci/Mity_zwiazane_z_Rekomendacja_T.html

watching that dispute with great attention, ready to react – similar situation in 2006 year when the first Recommendation S was announced led to a mortgage boom. The confrontation ended with some softening of the KNF's regulations.¹⁸

The analysis of reactions of the Polish banking system which took place in those weeks which passed since the enactment of both Recommendations shows that although banks made some necessary changes in their regulations, they decided also to give a wide interpretation on them. As a result that mentioned above limit of ratio debt-to-income which should not be higher than 65% of monthly income of the borrower on condition that his income is above the country's average, according to the data provided by Open Finance Agency¹⁹ in case of some banks still reaches 75% ,while in others does not exceed 50%, due to the fact the Recommendation does not state which months should be taken under consideration and how often that data should be updated.

Still, the general reaction of the banking system to the recent changes of regulations regarding mortgages can be called a smoothening of lending policies.²⁰ According to the data provided by the Union of Polish Banks in the last quarter of year 2010 the number of credits with lowered down payment levels grew (by 17%), many banks decided to offer more competitive credit margins, but at the same time due to the implementation of the Recommendation T banks have sharpened their criteria of creditability assessment.

It may look like lack of cautionary measures on their side, but almost all Polish banks reacted to what was happening on the financial market even before the regulator enforced these new rules. They introduced their own regulations in order to rebalance credit portfolio, in some cases they even stopped granting mortgage loans in certain currencies to reduce the risk. There were even cases where the KNF had to intervene in order to protect interest of some banks' customers as banks started to demand from them acceptance of some changes of credit contracts in order to change the currency structure in their mortgage portfolio.²¹

Majority of Polish banks decided to convert generated in year 2009 profits into capital to enhance their ability to absorb risk, but at the same time as

¹⁸ Armada-Rudnik P., „Prawo hipoteczne po nowelizacji z 26.06.2009r., Monitor prawniczy, 2010, no 1 7-15

¹⁹ Sadrak M., „Rekomendacja T nie dla wszystkich”, 2011, February 22, 2011, <http://prnews.pl>

²⁰ Nierodka A., „Mortgage Climate” (Report no 3, 2010), March 26, 2011, www.ehipoteka.pl

²¹ ibidem

the competition between credit institutions in Poland is very fierce, they also learned how to put an interpretation on some binding them regulations to be able to offer more than their competitors.

Still, these recent efforts, although they are steps in good direction, as they solve some local problems and make a mortgage more affordable and flexible instrument, in larger perspective are just a beginning of a long process of adjusting regulations to demands of the modern integrated financial market. Those already taken measures do not ensure fair competition between domestic and foreign credit institutions, they do not enhance the cross-border availability of the product, and fail to create risk reducing instruments that would make both mortgage lenders and borrowers more interested in the cross-border transactions. It cannot be achieved without some changes in legislation regulating enforcement of collateral, establishing of cross-border standards of property valuation, improvement to the exchange of information between domestic and foreign credit bureaux, as well as ameliorating of land register, but first of all without paying attention to the demands of modern market.

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