EUROPEAN CENTRAL BANK

EUROSYSTEM

OPINION OF THE EUROPEAN CENTRAL BANK

of 4 August 2010

on amendments to various laws regarding the reduction of financial imbalances

(CON/2010/62)

Introduction and legal basis

On 5 July 2010, the European Central Bank (ECB) received a request from the Hungarian Ministry of the National Economy for an opinion on a draft law amending certain financial legal acts (hereinafter the 'draft law')[1].

The ECB's competence to deliver an opinion is based on Articles 127(4) and 282(5) of the Treaty on the Functioning of the European Union and the sixth indent of Article 2(1) of Council Decision 98/415/EC of 29 June 1998 on the consultation of the European Central Bank by national authorities regarding draft legislative provisions[2], as the draft law relates to rules applicable to financial institutions in so far as they materially influence the stability of financial institutions and markets. In accordance with the first sentence of Article 17.5 of the Rules of Procedure of the European Central Bank, the Governing Council has adopted this opinion.

1. Purpose of the draft law

On 8 June 2010, Hungary's Prime Minister announced an action plan containing 29 measures to establish a balanced budget and to stimulate economic growth. The provisions submitted to the ECB for consultation aim to implement several of these measures, including introducing restrictions on foreign currency mortgages and earning limits for certain organisations in the public sector; imposing a special tax on financial institutions; providing for the repayment of State subsidies on housing saving plans under certain conditions; introducing certain organisational changes at the Hungarian Financial Supervisory Authority and introducing certain amendments to the Law on strengthening stability of the financial intermediation system.

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1 Draft law T/581 on the adoption and amendment of certain economic and financial legal acts, submitted to the Parliament by the Minister for the National Economy on 2 July 2010. Articles 81 to 83/A, 95 to 96, 115 to 129, 131, 137 to 138 and 141 to 143 have been submitted to the ECB.

2 OJ L 189, 3.7.1998, p. 42.

2. General observations

The appropriate time to consult the ECB

2.1 The consulting authority submitted the relevant Articles of the draft law to the ECB on 5 July 2010, requesting the ECB's opinion as soon as possible. The consulting authority did not set the ECB any specific time limit for the submission of its opinion nor provide justified reasons for the urgency. The ECB interprets the request in accordance with Article 3(1) of Decision 98/415/EC allowing the ECB at least one month for the submission of its opinion. According to information received by the ECB, the Parliament expects to adopt the draft law before the extraordinary summer session of the parliamentary legislative process ends. According to the information available on the website of the Hungarian Parliament, the provisions of the draft law sent for consultation have already been adopted with several substantive amendments on 22 July 2010 before the ECB could adopt its opinion.

2.2 Recalling its relevant comments in its previous opinion on a related issue in Hungary[3], the ECB emphasises that the consultation should have taken place at a point in the legislative process which would have afforded the ECB sufficient time to examine the draft legislative provisions and to adopt its opinion in all required language versions, and which also would have enabled the relevant national authorities to take the ECB's opinion into consideration before the provisions were adopted. According to Article 3(4) of Decision 98/415/EC, Hungary should have suspended the adoption process for the draft law, pending receipt of the ECB's opinion.

2.3 Furthermore, the opportunity to issue an opinion on a draft law within its competence allows the ECB to express its views on the substance of the proposed legislation, including considerations such as the importance that the ECB may attach to a particular legislative proposal and its potential impact on the European System of Central Banks. Therefore, the ECB reiterates its position that even cases of particular urgency do not relieve national authorities from their duty to consult the ECB and to allow sufficient time to take into account its views in accordance with Decision 98/415/EC. Any substantive amendments to the draft law – as in the case of the provisions subject to this consultation – have to be submitted to the ECB to allow it to issue its opinion based on the most recent text. The ECB's comments on the consulted provisions do not eliminate the breach of the obligation to consult the ECB. Even though the provisions have already been enacted, the ECB considers that its comments are important for the application and interpretation of the enacted law and any future amendments. The ECB also emphasises that it expects the Ministry for the National Economy to give due consideration to honouring its obligation to consult the ECB in accordance with Decision 98/415/EC.

Legislation subject to consultation

2.4 Although the draft law amends several legal acts, this opinion only covers the provisions of the draft law that the consulting authority has submitted for consultation. ECB Opinion CON/2010/56

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3 ECB Opinion CON/2010/56. All ECB opinions are published on the ECB's website at www.ecb.europa.eu.

has already addressed Article 95. The ECB also advises that this opinion is without prejudice to any other ECB opinions concerning any other legal acts possibly affected by the draft law and falling under the ECB's competence. The ECB expects to be consulted on all such matters.

3. Financial stability

Restrictions on foreign currency mortgages

3.1 Articles 81 and 82 of the draft law amending respectively the Hungarian Civil Code and the Law on the Land Register with future effect prohibit entering into or claiming a right as a result of foreign currency mortgages contracted by individuals in the Land Register. Article 82(2) introduces the possibility of a collateral swap or refinancing operations in case of all such mortgages entered into the Land Register before the draft law enters into force. Under Article 262 of the Civil Code real property may be pledged as security only in the form of a mortgage, and a mortgage is valid only if contracted in writing and recorded in the Land Register. Therefore, the practical consequence of Articles 81 and 82 of the draft law is that after the draft law enters into force, claiming a new right as the result of mortgages contracted by individuals in a foreign currency is no longer possible since it cannot serve as adequate security because its entry in the Land Register will be prohibited.

3.1.1 The ECB notes that high levels of foreign currency loans to unhedged borrowers are an important vulnerability in Hungary, as they convert direct exchange rate exposure of the banking system into credit risk and expose the economy to significant macro-financial risks. Furthermore, a high level of foreign currency debt may restrict the room for monetary policy manoeuvre and its effectiveness. Given these negative side effects associated with foreign currency lending, it is important for policymakers to take measures to avoid its excessive build-up in the banking system.

3.1.2 To contain foreign currency lending, policymakers are strongly encouraged to create an overall environment for economic agents which encourages prudent and well-informed decision making. This involves the pursuit of sound and stability-oriented macroeconomic policies and policies to strengthen financial literacy and appropriate financial regulation and supervision. If this proves insufficient, additional policies to prevent an excessive build-up of foreign currency debt, such as moral suasion and administrative measures, could be considered.

3.1.3 Against this background the ECB welcomes the general objective of the Hungarian authorities of limiting the building up of further macro-financial imbalances and takes note of the recent changes in Hungary's regulation of foreign currency lending. In particular, Government Decree 361/2009[4] has already tightened credit standards substantially by defining relative lending limits and maximum loan-to-value ratios and by introducing additional stricter criteria for foreign currency mortgages, depending on the currency of denomination. The efficient implementation and thorough

4 **361/2009.** (XII. 30.) *Korm. rendelet. a körültekintő lakossági hitelezés feltételeiről és a hitelképesség vizsgálatáról.*

assessment of the measures laid down by Government Decree 361/2009, as well as the improvement in banks' risk management practices, should be emphasised. More generally, there is a need to ensure that strict and prudent regulatory and administrative measures are in place for lending to unhedged domestic borrowers in a foreign currency. In addition, banks should always hold sufficient capital to reflect the specific risks associated with foreign currency lending, in particular as regards the transformation of exchange rate risk into credit risk.

3.1.4 If the proposed complete ban on individuals taking foreign currency mortgages in Articles 81 and 82 of the draft law has a cross-border effect, it may raise issues of compliance with Article 63 of the Treaty on free movement of capital and payments[5]. The ECB appreciates that the free movement of capital and payments is without prejudice to, *inter alia*, 'measures which are justified on grounds of public policy or public security', as laid down in Article 65(1)(b) of the Treaty. As in the case of exceptions based on the principle of general good, the exemption in Article 65(1)(b) of the Treaty is narrowly interpreted by the Court of Justice of the European Union, with the implication that any such measure would, for example, need to meet the proportionality test. Under this test, restrictions are justified only if no less restrictive measure would suffice to reach the desired end. The final assessment of whether the complete ban on individuals taking foreign currency mortgages is in breach of the free movement of capital and payments is entrusted to the Union institutions ensuring the application and observance of the Treaties.

Special tax imposed on financial institutions

3.2 Articles 115 to 120 of the draft law amending the Law on a special tax and contribution to balance the State budget impose a special tax on financial institutions. According to Article 116, financial institutions whose annual report closed on 1 July 2010 will be subject to a special tax in 2010. The rate will depend on the form of the financial institution.

3.2.1 The ECB notes that the feasibility of a tax on financial institutions should be considered in relation to the objectives of covering the public cost arising from their failure and of addressing the risks posed by them. The proceeds raised by the tax should preferably accrue to the deposit guarantee schemes or to resolution funds set up ex-ante that would need to be supported by a robust resolution framework. Furthermore, the proceeds from a bank tax should be ring-fenced to avoid their use for general fiscal consolidation purposes. In this context, the draft law raises the following concerns.

3.2.2 First, using the proceeds for general budget purposes is not desirable as it does not serve the general objective of enhancing financial stability. In particular, given the magnitude of the proposed measure, the marked deterioration of the financial sector's capital accumulation ability may weaken its solvency position, thereby making the financial system more vulnerable to potential further shocks.

5 See Case C-464/98, *Westdeutsche Landesbank Girozentrale* v *Stefan and Republik Österreich* [2001] ECR I-173.

Second, the tax may hamper the provision of bank credit to the non-financial private sector and result in extra charges to customers. In particular, banks which aim to partly offset the unexpected taxes may increase their margins, thus making credit to households and enterprises more expensive. This, in turn, would lead to even weaker domestic demand growth, thereby delaying recovery of the Hungarian economy.

Third, as a response to the substantial increase in the tax burden, some banks and other financial institutions may cut back their activities in Hungary, thus further limiting the availability of financing.

Finally, such ad hoc taxing of an industry may create uncertainty for business and thus have a detrimental impact on long term growth.

Given these concerns, the ECB strongly recommends a comprehensive impact assessment of the proposed measure.

3.2.3 Article 118(7) stipulates only the total amount of levy to be paid by the financial sector in 2011 without specifying the details of the tax. In addition, Article 118(8) does not specify the total amount of tax to be imposed on the financial sector in 2012. These measures will be laid down in a separate law, which creates additional uncertainty. For the sake of legal clarity and the predictability of the business environment, the ECB would welcome defining the actual tax measures for 2011 and 2012 in the draft law.

This opinion will be published on the ECB's website.

Done at Frankfurt am Main, 4 August 2010.

[signed]

The President of the ECB

Jean-Claude TRICHET