EUROPEAN CENTRAL BANK

EUROSYSTEM

OPINION OF THE EUROPEAN CENTRAL BANK

of 4 November 2011

on foreign currency mortgages and residential property loan agreements

(CON/2011/87)

Introduction and legal basis

On 19 September 2011, the European Central Bank (ECB) received a request from the Hungarian Ministry for the National Economy for an opinion on a draft law amending certain laws in relation to protecting homes (hereinafter the 'draft law').

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[1], as the draft law relates to rules applicable to financial institutions insofar 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

The draft law will amend the following legislation to establish a relief scheme for distressed borrowers in a foreign currency: (i) Law No XCIII of 1990 on duties, (ii) Law No CXVII of 1995 on personal income tax, (iii) Law No LXXXV of 1996 amending Law No XCIII of 1990 on duties and on administrative charges for certified copies of title deeds , (iv) Law No CXII of 1996 on credit institutions and financial enterprises (hereinafter the 'Law on credit institutions'), (v) Law No XXX of 1997 on mortgage credit institutions and mortgage debentures, and (vi) Law No LXXV of 2011 on the system for the forced sale of residential properties and fixing the exchange rate for repayment of foreign-currency loans.

The scheme applies to foreign currency loan agreements entered into by consumers with a State guarantee pursuant to Article 44 of Law No CXXXV of 2004 on the Republic of Hungary's budget for 2005[2], or a mortgage on a residential property in Hungary, and specifies the conditions for early repayment of the total amount payable by the consumer. In such cases, the financial institution which has granted the foreign currency loan, when defining the forint amount of the early repayment, must apply an exchange

1 OJ L 189, 3.7.1998, p. 42.

2 According to this provision, the State guarantee applies to loan agreements following 31 December 2004 for residential real estate.

rate of 180 HUF/CHF for Swiss francs, 250 HUF/EUR for euro and 200 HUF/100 JPY for yen[3] where all of the following criteria are met:

(a) the exchange rate used at the time the financial institution extended the loan affected by early repayment was not higher than the fixed exchange rate;

(b) the financial institution has not terminated the loan agreement by the date on which the draft law takes effect,

(c) the borrower submits to the financial institution providing the foreign currency loan a written claim for early repayment by 30 December 2011,

(d) the borrower agrees, when filing a claim, to repay early any debt arising from bridge or combined account loans directly related to the foreign currency loan[4].

If these criteria are met, the financial institution may not refuse a claim for early repayment and is obliged to arrange for closure directed at early repayment of the contract within 60 days of a claim[5]. The financial institution may not charge for payment of expenses and other fees or commissions defined in Law No CLXII of 2009 on credit provided to consumers for early repayment[6].

Also, in case of foreign currency loan agreements with consumers, the financial institution may solely charge in foreign currency for costs and fees directly related to the acquisition of foreign currency resources to fulfil and support the relevant contract, including interest-type handling costs[7]. The draft law also provides that fees and costs related to entering into contracts, correspondence, statements and certificates, visits to customers, credit monitoring, notice of termination, collateral valuation and replacement, amendments to the contract, credit repayment insurance services or administration of the credit agreement and associated closure of the credit account may not be charged to the consumer in foreign currency[8].

2. General observations

The appropriate time to consult the ECB

2.1 The consulting authority submitted the draft law to the ECB on 19 September 2011 without (i) requesting an urgent procedure and (ii) setting an express time limit for the submission of the ECB's opinion. On the same day, the Hungarian Parliament adopted the draft law which entered into force on the third day following its publication, i.e. on 29 September 2011 (hereinafter 'the Law'). The ECB is also aware of the fact that another draft law amending certain provisions of the Law was adopted by the Parliament on 10 October 2011.

3 Article 200/B(1) to be inserted into the Law on credit institutions.

4 Article 200/B(2) to be inserted into the Law on credit institutions

5 Article 200/B(3) to be inserted into the Law on credit institutions.

6 Article 200/B(4) to be inserted into the Law on credit institutions.

7 First sentence of Article 210(5a) to be inserted into the Law on credit institutions.

8 Second sentence of Article 210(5a) to be inserted into the Law on credit institutions.

2.2 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 have to be submitted to the ECB to allow it to adopt its opinion on the most recent text. Furthermore, the process of adoption of the draft law should have been suspended. The ECB's observations on the provisions on which it was consulted do not eliminate the breach of the consultation obligation. The ECB would appreciate the Ministry for the National Economy giving due consideration to honouring its obligation to consult the ECB in the future.

3. Specific observations

3.1 *Financial stability and risks associated with foreign currency loans*

The ECB has pointed out on several occasions the risks associated with foreign currency loans[9]. In particular, foreign currency loans represent a major risk to financial stability in several Member States in central and eastern Europe, particularly in Hungary where the share of foreign currency loans - especially those denominated in Swiss francs - is among the highest in the Union.

The ECB in principle welcomes measures promoting responsible lending by credit institutions, enforcing market discipline and increasing the transparency of credit institutions' activities to provide a higher level of consumer protection, especially in the area of loans relating to residential property[10]. The proposal for a directive of the European Parliament and of the Council on credit agreements relating to residential property points to that direction by stating that foreign currency loans taken out by consumers to take advantage of the interest rate offered, but without having an adequate understanding of the currency risk involved, has posed problems in the EU mortgage markets[11]. The European Systemic Risk Board (ESRB), in considering options to reinforce the resilience of the Union financial system, has identified as one of the challenges the potential problems arising from foreign currency borrowing by households and small and medium-sized enterprises within the Union. National authorities will need to take into consideration the ESRB recommendations recently adopted in this area[12].

3.2 *Assessment of the Law*

The ECB notes the risks incurred by consumers when subscribing to foreign currency loans and the willingness of the Hungarian authorities to take policy action in this area in view of the importance of these foreign currency loans in Hungary. While noting the importance of complying with the rule of law and ensuring legal certainty, the ECB further observes in this respect that the Law is the latest effort of the Hungarian Government to provide relief for distressed foreign currency borrowers and thus ease the burden on the Hungarian economy. On 20 June 2011, the Hungarian

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9 ECB Financial Stability Report of June 2010. All ECB documents are available on its website at www.ecb.europa.eu.

10 ECB Opinions CON/2010/62, CON/2011/58, CON/2011/67 and CON/2011/74.

11 Recital 4 (COM(2011)142.final).

12 See ESRB Recommendation ESRB/2011/1 of 21 September 2011 on lending in foreign currencies available on the ESRB's website at www.esrb.europa.eu.

Parliament adopted Law No LXXV of 2011 without consulting the ECB[13]. The ECB is not aware of any evaluation of the effect of previous efforts by the Hungarian authorities to curb foreign currency loans.

As regards the scheme introduced by the Law, the ECB has the following concerns.

First, the ECB considers that, in allowing borrowers to repay their debt at fixed exchange rates substantially below current market rates, the Law creates a situation that can substantially weaken the banking system's stability and is likely to also have adverse spillover effects on the economy.

Second, depending on take-up rates by debtors, the one-off losses for the Hungarian banking system from the repayment of foreign currency mortgages under the Law could adversely affect banks' capital position at a time when their ability to accumulate capital by retaining earnings remains constrained, in part, by the financial sector tax introduced last year[14]. As around 60% of the Hungarian banking sector is owned by foreign banking groups, cross-border spillover effects are expected since early repayments below current market rates could impact these banking groups' consolidated profits. While parent undertakings of Hungarian banks established in other countries (hereinafter the 'parent banks') should be able to absorb the immediate financial impact, the Law, together with the financial sector tax, could increase the risk that parent banks reallocate some of the funds from their Hungarian subsidiaries to other subsidiaries which could deteriorate Hungarian banks' lending capacity in the longer term.

Third, in addition to the immediate adverse financial impact on the banking system, there may also be a number of negative macroeconomic externalities for the Hungarian economy including: (i) depreciation pressure on the exchange rate, (ii) higher country risk premia, (iii) upward pressure on domestic interest rates, (iv) weaker growth due to a further fall in lending activity and tighter credit conditions, and (v) deteriorating foreign investor sentiment as a result of an increase in legal uncertainty and perceived country risk.

Fourth, the Law may also have a negative impact on public finances, among other factors due to an increase in the country risk premium reflecting potential problems in the banking system and the negative growth impact of the Law. While, at this stage, it is difficult to quantify the overall macroeconomic impacts, the net short term effect for growth is likely to be negative for Hungary.

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13 According to Law No LXXV of 2011, debtors may opt for a 36 month application of a fixed exchange rate of forint 180/1 Swiss francs, forint 250/1 euro and forint 200/100 yen. During that period, they will receive a credit line to accumulate the difference between the fixed and the actual exchange rates. After the period of application of the fixed exchange rates, debtors must repay the accumulated difference on a monthly basis. Law No LXXV of 2011 also introduces a quota for the forced sale of properties.

14 See paragraph 3.2 of Opinion CON/2010/62.

Fifth, in a previous opinion on the ban on individuals taking foreign currency mortgages[15], the ECB pointed out that, if the proposed 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[16]. The ECB also noted on this occasion 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. However, 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 ECB considers that the assessment of whether the measures imposed on financial institutions under the Law are in breach of the free movement of capital and payments, the freedom of establishment or other Union rules is entrusted to the Union institutions ensuring the application and observance of the Treaties.

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

Done at Frankfurt am Main, 4 November 2011.

[signed]

The Vice-President of the ECB

Vítor CONSTÂNCIO

15 See paragraph 3.1.4 of Opinion CON/2010/62. In 2005, interest rates on mortgages denominated in foreign currencies such as Swiss francs and euro were around 4%, while rates on forint loans could be twice as much. Applying the lower monthly payments, a buyer could qualify for a loan in foreign currencies which exceeded the amount for which he could receive a loan in forint. As a result, Hungarian consumers had borrowed large amounts in Swiss francs before the start of the global crisis in 2008. When the exchange rate between forint and other currencies began to widen as a result of the crisis, credit institutions offered to extend loan periods, so that foreign currency borrowers could make lower monthly payments. The Government prohibited individuals from taking foreign currency mortgages. The ECB understands that the Law was subsequently amended on 1 January 2011 to take into account the ECB's concerns.

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