EUROPEAN CENTRAL BANK
EUROSYSTEM

OPINION OF THE EUROPEAN CENTRAL BANK

of 5 April 2012

on foreign currency mortgages and residential property loan agreements

(CON/2012/27)

Introduction and legal basis

On 12 March 2012, the European Central Bank (ECB) received a request from the Hungarian Ministry for the National Economy for an opinion on a draft law modifying the rescue scheme for foreign exchange borrowers (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 amends Law LXXV of 2011 fixing the exchange rates for the repayment of foreign currency loans and the administration of the enforced sale of residential property[2] (hereinafter the Law) that, in July 2011, introduced a scheme to fix loan instalments on a temporary basis by collecting the additional debt arising from the difference between the actual and fixed exchange rates on a separate loan account, which was to be repaid after 36 months. The ECB was not consulted on this Law. On 10 October 2011, the Law was amended to allow eligible debtors to repay mortgages early at exchange rates fixed by the Government, implying a significant reduction in the principle amount of the mortgages. The early repayment scheme expired on 29 February 2012.

On 30 December 2011, the relief scheme was again amended by inserting an article into a legal act regulating a materially different subject matter, Law CCIX of 2011 on water utilities. This amendment provided relief for holders of foreign currency mortgages who on 30 September 2011 had been in default

1 OJ L 189, 3.7.1998, p. 42.

2 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 franc, 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 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

for more than 90 days with an arrear amounting at least to the Hungarian minimum wage. The debtor could request conversion into a mortgage denominated in forint. In addition, 25% of the clients' debt outstanding on 15 May 2012 would be cancelled, provided the total market value of the real estate serving as collateral did not exceed HUF 20 million at the time of contracting the foreign currency mortgage. The ECB was not consulted on this amendment.

The latest draft amendments to the Law aim to make the initial scheme more attractive to debtors unable to repay their foreign currency loans under it.

The draft law also extends the scope of debts qualifying as a foreign currency loan to debts under a financial leasing contract. Furthermore, it extends the scope of the exchange rate barrier scheme to debtors with loans up to HUF 20 million. It also extends the scheme's application period from 36 to 60 months and introduces the concepts of 'highest exchange rate' and 'exempted part of the debt'.

The draft law provides for the State reduction of the scheme's financial burden on financial institutions. It specifies the highest exchange rate in 270 forint/Swiss franc, 340 forint/euro and 3.3 forint/yen, beyond which the State undertakes to reimburse *a posteriori* on a quarterly basis the full amount of debt resulting from exchange rates in excess of the highest exchange rate. The concept of 'exempted part of the debt' covers any fees and interest on the loan if the exchange rate exceeds the fixed exchange rate of 180 forint/Swiss franc, 250 forint/euro and 2.5 forint/yen.

Furthermore, the State undertakes to reimburse the financial institutions *a posteriori* on a quarterly basis half of the exempted part of the debt that cannot be enforced in a foreclosure procedure. Financial institutions are prohibited from charging interest on the exempted part of the debt and the part of the instalment obligation that resulted from the exchange rate exceeding the highest exchange rate fixed by the draft law. Finally, the draft law provides for an additional interest subsidy for public sector employees.

On 14 March 2012, the Minister for the National Economy tabled six amendments to the draft law before the final parliamentary vote, including amendments T/5842/20 to 25. Contrary to the 30 December 2011 version of the draft law, amendment T/5842/25 extends the scheme to debtors with loans drawn against real estate collateral of up to HUF 30 million, compared with the cap on the initial amount of the mortgage of HUF 20 million. At the same time, amendment T/5842/23 inserts a new Article 10/A(1) into the Law providing relief for foreign currency debtors in default for more than 90 days at 30 September 2011 for at least an amount corresponding to the minimum wage. These debtors may request conversion into a forint mortgage loan and 25% of their debt outstanding on 15 May 2012 may be cancelled, provided that the total market value of the real estate serving as collateral did not exceed HUF 20 million at the time of contracting the foreign currency mortgage.

Amendment T/5842/24 complements Article 3(4) of the Law by introducing the following application schedule for eligible debtors to apply for conversion of their foreign currency loans:

- from the Law's entry into force: public sector employees,
- from 1 June 2012: other foreign currency mortgage holders,

- from 1 September 2012: other foreign currency mortgage debtors with a non-specified purpose loan.

The ECB was not consulted on these amendments to the draft law, which were incorporated in the final version adopted by the Parliament on 19 March 2012. Since the final adopted law had not been published by 26 March 2012, the ECB's opinion is based on the draft law sent by the consulting authority, supplemented by amendments from the Hungarian Parliament's on-line database.

2. The appropriate time to consult the ECB

The consulting authority submitted the draft law to the ECB on 12 March 2012, in a letter dated 28 February 2012, without requesting an urgent procedure or setting an express time limit for the submission of the ECB's opinion. On 19 March 2012, the Hungarian Parliament adopted an amended version of the draft law.

The ECB again 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 expects the Ministry for the National Economy to give due consideration to honouring its obligation to consult the ECB in the future.

3. Financial stability and risks associated with foreign currency loans

3.1 The ECB has pointed out on several occasions the risks associated with foreign currency loans[3]. In particular, they 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 is among the highest in the Union. The ECB points in this respect to the analysis of such risks made by the European Systemic Risk Board (ESRB) and to the ESRB recommendations for addressing such risks contained in Recommendation ESRB/2011/1 of 21 September 2011 on lending in foreign currencies[4].

3.2 While noting the importance of complying with the rule of law and ensuring legal certainty, the ECB observes that the draft law is the latest effort by the Hungarian Government to provide relief for distressed foreign currency borrowers and thus ease the burden on the Hungarian economy.

3.3 The ECB notes that the Hungarian authorities have found a common position with the Hungarian Banking Association including, inter alia, on burden sharing between banks, the Government and holders of foreign currency loans. This is a welcome development from a financial stability

3 See in particular the ECB Financial Stability Review of June 2010 and Opinion CON/2011/87. All ECB documents are available on its website at www.ecb.europa.eu.

4 OJ C 342, 22.11.2011, p. 1.

perspective. While previous amendments to the Law, especially those related to the early repayment of foreign currency loans, had a significant negative impact on financial stability[5], the current amendment may, in contrast, have a favourable impact on banks' asset quality, at least in the short to medium term. However, the long-term implications of the scheme for borrowers' financial position and banks' asset quality will depend, among other things, on exchange rate movements during and after the period of exchange rate fixing.

3.4 In addition, the ECB considers that, by allowing borrowers to service their debt for a period of 60 months at fixed exchange rates substantially below current market rates, the Law may weaken customers' risk awareness during the fixation period. This may represent a potential risk for the banking system's stability when the scheme expires and the instalments to be paid by clients will increase to service the debt accumulated on the separate loan accounts. It is therefore important for banks and authorities to ensure that clients are fully aware of the possible implications of a potentially sizeable increase in their monthly instalments at the end of their participation in the scheme. In this regard, the Hungarian authorities could consider appropriate measures to enhance clients' risk awareness and to encourage them to build up sufficient financial reserves that could be used to service their debt in the future.

3.5 The ECB reiterates its earlier concerns as regards the potential adverse effects of Law LXXV of 2011 and its amendments, with possible negative implications for the long-run growth prospects of the economy.

3.6 Overall, the ECB calls for an update of the analysis of the impact of Law LXXV of 2011 and its amendments on public finances, the financial system and the real economy including possible cross-border effects.

3.7 Finally, the ECB calls for further dialogue between the authorities and financial institutions and proposes in this regard due consideration of the interests of the general public, including financial institutions and the authorities responsible for ensuring the stability of the financial system in Hungary, in the process of developing secondary legislation, as referred to in Article 7 amending Article 11 of Law LXXV of 2011.

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

Done at Frankfurt am Main, 5 April 2012.

[signed]

The President of the ECB

Mario DRAGHI

5 See CON/2011/87.