EUROPEAN CENTRAL BANK

EUROSYSTEM

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ECB-PUBLIC

OPINION OF THE EUROPEAN CENTRAL BANK

of 18 December 2015

on discharge of mortgage-backed debts through transfer of title over immovable property

(CON/2015/56)

Introduction and legal basis

On 25 November 2015 a draft law on the discharge of debt obligations assumed through credit agreements by 'payment in kind' through the transfer of mortgaged property (hereinafter the 'draft legislative provisions')[1] was adopted by the Chamber of Deputies of the Romanian Parliament and, on 9 December 2015, was submitted for promulgation to the President of Romania. This is the last step in the legislative procedure before the draft legislative provisions become legally binding and of general application in Romania. The draft legislative provisions have not yet been promulgated by the President of Romania, who has the right to send the draft legislative provisions back to the Parliament for re-examination[2]. On 14 December 2015 the European Central Bank (ECB) was informed by the Banca Naţională a României (BNR) about the draft legislative provisions.

In light of the above, and in view of the potential impact of the draft legislative provisions on the stability of financial institutions and markets in Romania, the ECB has decided to deliver an own initiative opinion on the draft legislative provisions, since it has not been formally consulted by the Romanian legislator. 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[3], as the draft legislative provisions relate 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 legislative provisions

1.1 According to the explanatory memorandum, the aim of the draft legislative provisions is to balance the interests of the parties in a default or foreclosure situation related to credit agreements secured by a mortgage arrangement. In this respect, the scope of the draft legislative provisions covers any credit agreement between natural persons and financial institutions which is secured by a mortgage arrangement (hereinafter a 'credit agreement'). In addition, the draft legislative provisions

1 The ECB notes that the legislative initiative for the preparation of the draft legislative provisions was taken by members of the Romanian Parliament.

2 Alternatively, the President of Romania has the right to send the draft legislative provisions to the Constitutional Court, for review.

3 Council Decision 98/415/EC of 29 June 1998 on the consultation of the European Central Bank by national authorities regarding draft legislative provisions (OJ L 189, 3.7.1998, p. 42).

aim to transpose into Romanian law certain provisions of Directive 2014/17/EU of the European Parliament and of the Council[4].

1.2 Article 1(2) of the draft legislative provisions establishes a general right for debtors to discharge their debts and all accessory obligations under a credit agreement by transferring to the creditor the ownership title over the mortgaged immovable property, subject to compliance with the conditions set out in Article 4.

1.3 Article 4 of the draft legislative provisions sets out the following conditions for the full discharge of the debt*:* (i) the debtor is a natural person and the creditor is a credit institution, non-bank financial institution or an assignee of personal claims; (ii) the parties, or their predecessors, have entered into a credit agreement; and (iii) the property tendered in order to discharge the debt is the property mortgaged to secure the creditor's claims under the credit agreement.

1.4 The remaining key provisions of the draft legislative provisions lay down the particulars of the procedure for the mandatory transfer of title over a debtor's immovable property. Debtors can notify creditors at any time of their decision to transfer the ownership of immovable property in discharge of their debt under a credit agreement. Following such notification, creditors are under an obligation to convene with the notifying debtors before a public notary in order to execute the deed for the transfer of title in exchange for the discharge of all obligations under the credit agreement. Debtors may initiate court proceedings against creditors who fail to comply with this obligation, petitioning the court for the issuance of a court order *in lieu* of a transfer deed. Both the procedure before the public notary and such court proceedings may also be initiated by co-debtors or guarantors. It is worth noting that, according to Article 6(1), once the procedure has been initiated by sending the notification, the creditor's right of recourse against all co-debtors and personal or mortgage guarantors is extinguished.

1.5 Pursuant to Article 11 of the draft legislative provisions, the law applies both to credit agreements concluded after its entry into force as well as to all outstanding credit agreements.

2. General observations

2.1 It is noted that, given their wide scope, the draft legislative provisions would apply not only to consumer loans but also to commercial loans of natural persons, and to performing and non-performing loans alike. While the ability of financial institutions to effectively manage credit risk depends on a reliable, predictable and stable legal framework which adequately balances the interests of both the creditor and the debtor, the draft legislative provisions introduce unprecedented changes into the legal framework applicable to credit agreements in Romania which significantly undermine legal certainty and the adequate management of credit risk in financial institutions. The ECB notes that in response to the financial crisis several Union member states introduced new legal frameworks on personal debt restructuring, which in a very few cases included a limited right to return the mortgaged property *in lieu* of repayment. However the exercise

4 Directive 2014/17/EU of the European Parliament and of the Council of 4 February 2014 on credit agreements for consumers relating to residential immovable property and amending Directives 2008/48/EC and 2013/36/EU and Regulation (EU) No 1093/2010 (OJ L 60, 28.2.2014, p. 34).

of this right is not left to the discretion of the borrower, but rather is subject to compliance with strict economic and other eligibility criteria[5].

2.2 In this respect, the ECB advises the Romanian authorities to carefully consider the impact of the draft legislative provisions on existing credit agreements in order to ensure legal certainty and avoid undue interference with the contractual and property rights of credit institutions, and to prevent moral hazard from arising in the relationship between creditor and debtor[6]. The draft legislative provisions should strive to ensure an adequate balance between the general duty of debtors to meet their payment obligations – which is conducive to a prompt payment culture, the preservation of the soundness of credit institutions and the prevention of moral hazard – and the need to provide assistance to individuals in severe financial difficulties.

3. Specific observations

3.1 *Legal certainty*

3.1.1 It is for the Romanian authorities to assess whether the retroactive character of the draft legislative provisions is consistent with Romanian constitutional principles. However, the ECB notes that introducing measures with retroactive effect, such as the draft legislative provisions, risks undermining legal certainty and is not in line with the principle of legitimate expectations[7].

3.1.2 As noted in paragraph 1.1, the draft legislative provisions also apply to credit agreements for consumers relating to residential immovable property which fall within the scope of Directive 2014/17/EU. In particular, where a credit agreement relates to a foreign currency loan, Article 23 of Directive 2014/17/EU requires Member States to have in place an appropriate regulatory framework to at least ensure that the consumer has a right to convert the credit agreement into an alternative currency under specified conditions or that there are other arrangements in place to limit exchange rate risk[8]. However, pursuant to Article 23(5) of Directive 2014/17/EU, Member States may further regulate foreign exchange loans provided that such regulation is not applied with retrospective effect[9]. Subject to the European Commission's competence to monitor the implementation of Union law, the Romanian authorities are invited to consider whether the unilateral right of a borrower to fully discharge his debt under a foreign exchange loan agreement, as granted under the draft legislative provisions, would be in line with Article 23(5) of Directive 2014/17/EU.

3.1.3 The ECB is concerned also that the draft legislative provisions do not seem to be in line with Article 28(4) of Directive 2014/17/EU, according to which Member States shall not prevent the parties to a credit agreement from expressly agreeing that return or transfer to the creditor of the security or proceeds from the sale of the security is sufficient to repay the credit. Pursuant to

5 In particular, temporary arrangements were put in place in Portugal that provided for the possibility of *datio in solutum* where a debtor was confronted with very difficult financial constraints. Moreover, in Spain the return of residential immovable property *in lieu* of repayment was permitted subject to strict eligibility requirements.

6 See Opinions CON/2010/8, paragraph 2.4, and CON/2010/34, paragraph 2.1. All ECB opinions are available on the ECB website at www.ecb.europa.eu.

7 See Opinion CON/2015/32, paragraph 3.2.2.

8 See Article 23, paragraphs (1) to (4) of Directive 2014/17/EU.

9 See Article 23(5) of Directive 2014/17/EU.

Article 3 of the draft legislative provisions, by way of derogation from the relevant provisions of the Romanian Civil Code, debtors have the right to fully discharge their obligations by transferring ownership over mortgaged immovable property to their creditors. Creditors do not have the right to oppose the transfer of the mortgaged immovable property if the credit agreement falls within the scope of the draft legislative provisions and satisfies the related conditions for the applicability of the draft legislative provisions. The Romanian authorities are invited to liaise with the European Commission as to whether the draft legislative provisions are compatible with Directive 2014/17/EU.

3.1.4 The ECB also considers that the draft legislative provisions should sufficiently clarify how they interact with other related laws, such as Law No 151/2015 on insolvency proceedings for natural persons[10], and the release of natural persons from debt under that law. A comprehensive debt restructuring framework would be more effective in addressing the unique challenges of unsustainable personal indebtedness. Such a regime would set the right incentives for affected parties so that debtors who are genuinely over-indebted and their creditors are incentivised to agree on a restructuring either on a bilateral basis or in a multilateral setting, for example as part of formal proceedings, such as insolvency proceedings.

3.2 *Effects on the Romanian economy*

3.2.1 Granting general rights, such as those provided for in Article 1(2) of the draft legislative provisions, which are not targeted exclusively at debtors in need of social protection, may lead to moral hazard, and undermine the future supply of credit. Such rights can potentially incentivise debtors who have no genuine need for protection to speculate on changes in real estate prices and to stop meeting their obligations, even if they have the means to do so in full. In anticipation of the negative impact that such rights could have on payment discipline in Romania, banks could be pushed to tighten lending conditions and boost advance payments. Higher interest rates and restrictive lending to households and small businesses may adversely affect economic growth and job creation. Therefore any such rights should be targeted at vulnerable borrowers, and be accompanied by effective safeguards to prevent strategic defaults and avoid a negative impact on future lending. In the absence of any such conditions, the normal functioning of credit institutions may be strongly impaired, which might affect adversely the soundness of individual credit institutions and – through contagion effects – pose substantial risks to the whole financial system. If such risks to the proper functioning of the credit channel were to materialise potential negative spillover effects on the economy would be likely[11].

3.2.2 The draft legislative provisions might also lead to a deterioration of foreign investor sentiment due to a perceived increase in legal uncertainty and country risk. Consequently, the ECB suggests that the Romanian authorities carry out a thorough analysis of the possible effects on the Romanian economy of introducing the draft legislative provisions[12].

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10 Law no. 151/2015 on insolvency proceedings for natural persons, published in *Monitorul Oficial al României*, Part I, No 464 of 26 June 2015.

11 See Opinion CON/2015/14, paragraph 2.3.

12 See Opinion CON/2015/32, paragraph 3.1.2.

3.3 *Effects on financial stability*

3.3.1 From a financial stability perspective, potential concerns about the impact on credit institutions, which need to be assessed from the outset, are related to: (i) the risks associated with foreign currency loans; (ii) the retrospective effects of the draft legislative provisions, also affecting outstanding credit arrangements; and (iii) the implications for prudential requirements for credit institutions in relation to mortgages on residential property to appropriately reflect the riskiness of related portfolios. Therefore, the ECB stresses the importance of a thorough impact analysis of the practical implications of the draft legislative provisions for the business of domestic credit institutions and, more broadly, for the Romanian real estate market. Given the significance of the interests at stake, both for affected credit and other financial institutions, as mandatory recipients of real estate assets, as well as the owners of other real estate assets in Romania, it is only with the benefit of a prior assessment that it might be possible to mitigate ensuing risks to financial stability.

3.3.2 As regards the longer-term effects on financial stability, the ECB notes that the draft legislative provisions will also apply to foreign currency loans. The ECB considers that, when introducing measures in relation to settling foreign currency loans, due consideration should always be given to fair burden-sharing among all stakeholders, thus also averting moral hazard in the future. The ECB has, on several occasions, pointed out the risks associated with foreign currency loans[13]. The draft legislative provisions do not seem to contain any safeguards in this respect.

3.4 *Effects on the banking sector*

The draft legislative provisions may have negative implications for credit institutions, with a potential impact on profitability, capitalisation and future lending capacity, the functioning of the financial system, as well as on the overall cost and conditions of credit[14]. In a worst case scenario, such implications could lead to capital shortfalls, potentially requiring prudential measures. It is noted that, should the draft legislative provisions enter into force, Romanian credit institutions would need to engage in the business of managing the real estate assets tendered to them in discharge of debts due to them under credit agreements.

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

Done at Frankfurt am Main, 18 December 2015.

[signed]

The President of the ECB

Mario DRAGHI

13 See, most recently, Opinion CON/2015/32. Regarding foreign currency loans in Hungary, see also Opinions CON/2011/87, CON/2012/27, CON/2014/59, CON/2014/72 and CON/2014/76 and, regarding foreign currency loans in Poland, Opinion CON/2015/26.

14 See Opinions CON/2010/8, paragraphs 2.3 and 2.4, and CON/2010/34, paragraph 2.3.