OPINION OF THE EUROPEAN CENTRAL BANK
of 11 December 2023
on a temporary mortgage loan borrower protection fee payable by credit institutions
(CON/2023/42)

Introduction and legal basis

On 30 November 2023 the European Central Bank (ECB) received a request from the Budget and Finance (Taxation) Committee of the Latvian Parliament (hereinafter the ‘Committee’) for an opinion on a draft law amending the Law on consumer rights protection1 (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 third and sixth indents of Article 2(1) of Council Decision 98/415/EC2, as the draft law relates to Latvijas Banka, contains rules applicable to financial institutions insofar as they materially influence the stability of financial institutions and markets, and concerns the ECB’s tasks concerning the prudential supervision of credit institutions pursuant to Article 127(6) of the Treaty. 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

1.1 The objective of the draft law is to establish a support mechanism consistent with the principle of a socially responsible State and aimed at mortgage borrowers for the purpose of house purchases or construction to safeguard the welfare of society, taking account of the considerable burden borne by households resulting from the increase in loan payments and consumer prices driven by the rise in the EURIBOR rate and inflation3. The explanatory memorandum accompanying the first draft of the draft law produced by the Committee4 referred to the preamble of the Latvian Constitution which defines Latvia as a socially responsible State, justifying the need for horizontal support measures. The consultation request notes that ongoing dialogue with banks has not brought any tangible results in terms of increasing deposit rates and reducing mortgage loan interest rates and bank service fees, and that, therefore, administrative measures providing support to mortgage payers are considered necessary to protect them in their capacity as consumers.

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1 Patērētāju tiesību aizsardzības likums, Latvijas Vēstnesis, 104/105, 1.4.1999.
3 See Article 1 of the draft law introducing Section 8.4(1) into the Law on consumer rights protection.
4 The draft law has evolved considerably since its inception, and no explanatory memorandum was submitted with the consultation request.
1.2 The draft law provides that credit institutions and companies, as well as permanent establishments (branches) in Latvia of foreign credit institutions and companies, that have received a special permit (licence) for the provision of consumer lending services in Latvia (hereinafter ‘fee payers’ or, in the singular, ‘fee payer’) will be under an obligation to pay a mortgage borrower protection fee.

1.3 The mortgage borrower protection fee will be set at 0.5% per quarter of the total amount of outstanding mortgage credits issued by the fee payer as at 31 October 2023. The fee will be paid into a dedicated income account of the central government basic budget by the 23rd day of the first month of the reporting quarter. The fee is of a temporary nature: it will be applicable for 2024. The fee will not be applied to mortgage credits issued with fixed interest rates for the entire mortgage credit repayment period.

1.4 The fee will be administered by the State Revenue Service (SRS). Fee payers will be obliged to submit to the SRS the following information regarding each mortgage borrower: (1) first name, surname, personal identity number; (2) the number of the bank account to which the credit interest rate compensation is to be credited; and (3) the credit interest rate compensation calculated. The SRS will transfer the credit interest rate compensation to the borrower’s bank account once per quarter.

1.5 The mortgage borrowers eligible to receive compensation are consumers with whom the fee payer has concluded a mortgage credit agreement provided that (1) the mortgage credit agreement was concluded by 31 October 2023 and the real estate pledged as collateral is located in Latvia, and (2) the outstanding mortgage credit does not exceed EUR 250 000. The amount of the credit interest rate compensation for each relevant mortgage is set at 30% of interest payments calculated in compliance with the relevant mortgage credit agreement for the respective quarter, but the compensation is limited to a level equal to no more than two percentage points from the interest rate set for that period.

1.6 The draft law clarifies that disputes between a customer and a fee payer regarding the calculation of credit interest rate compensation are to be resolved in accordance with the procedure laid down in the Law on civil procedure.

2. General observations

The ECB has recently adopted opinions on measures driven by similar considerations as the draft law, including a draft Italian law on the imposition of an extraordinary tax on credit institutions, a draft Lithuanian law establishing a temporary solidarity contribution applicable to credit institutions, a draft Slovenian legislative provision imposing a temporary tax on the balance sheets of banks and savings banks and a draft Spanish law on the imposition of temporary levies on operators in the energy sector, credit institutions

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5 The draft law has been further revised since its submission to the ECB for consultation and it was passed at a third and final reading on 6 December 2023. In the present opinion the ECB refers to the text of the law, namely the Amendments to the Consumer Rights Protection Law (Nr.367/Lp14) submitted for adoption at third reading, available on the Latvian Parliament’s website at www.saeima.lv.
7 See Opinion CON/2023/26. All ECB opinions are published on EUR-Lex.
9 See Opinion CON/2023/35.
and financial credit establishments\textsuperscript{10}. In these opinions, the ECB considered legislative initiatives introducing temporary levies and taxes applicable to credit institutions from the monetary policy, financial stability and prudential supervision perspectives.

3. The appropriate time to consult the ECB

The ECB notes that the draft law was already passed by the Latvian Parliament on 6 December 2023, but that the legislative procedure is not yet complete pending promulgation by the President or referral back to the Parliament\textsuperscript{11}. The ECB must be consulted at an appropriate stage in the legislative process. The ECB has emphasised on several occasions in its opinions that even in cases of particular urgency, or where the legislation has reached an advanced stage, the national authorities are not relieved of their duty under Articles 127(4) and 282(5) of the Treaty to consult the ECB at an appropriate stage in the national legislative process that allows sufficient time for (1) the ECB to examine the draft legislative provisions and (2) the relevant national authorities to take the ECB’s opinion into consideration before the provisions are adopted\textsuperscript{12}.

4. Monetary policy considerations

4.1 The euro area inflation rate reached record levels over the course of 2022 and posed significant challenges for the conduct of monetary policy. Guided by its primary objective of maintaining price stability, the ECB has taken determined action to ensure a timely return of inflation to the 2\% target over the medium term. Key ECB policy rates were raised by a cumulative 450 basis points between July 2022 and September 2023, with the intention of dampening demand and guarding against the risk of a persistent upward shift in inflation expectations. In parallel, net purchases of assets have ended, the asset purchase programme’s portfolio is declining at a measured and predictable pace, and the ECB stands ready to adjust all instruments within its mandate to ensure that inflation returns to the ECB’s medium-term target and to preserve the smooth functioning of monetary policy transmission.

4.2 The conditions on which borrowers access bank credit play an important role in the impact of the transmission of monetary policy on aggregate demand and ultimately on inflation rates. The recent increases in policy rates have so far been rapidly transmitted to Latvian lending rates on housing loans. If implemented, the draft law would impair the pass-through of higher rates to household borrowing conditions net of the envisaged 30\% credit interest rate compensation.

4.3 Evidence shows that banks’ net interest income typically tends to expand on impact as policy rates increase. This effect is faster the greater the weight of short-term or variable interest rate loans within bank balance sheets. However, as the tightening cycle proceeds, this positive income effect can be offset by lower lending volumes, a higher cost of funding, losses recorded in the securities portfolio and an increase in provisions resulting from potential deterioration of the quality of the credit portfolio.

\textsuperscript{10} See Opinion CON/2022/36.

\textsuperscript{11} See Article 71 of the Constitution of the Republic of Latvia (Latvijas Republikas Satversme), Latvijas Vēstnesis, 43, 1.7.1993.

\textsuperscript{12} See, for example, paragraph 2.1 of Opinion CON/2019/9, paragraph 2.1 of Opinion CON/2018/42 and Chapter 2 of Opinion CON/2014/87.
The realisation of downside risks in the current environment may significantly reduce the repayment capacity of debtors and translate into lower bank profitability. The net effect of tighter monetary policy on bank profitability when measured across the policy cycle may therefore be less positive, or even negative, over an extended horizon\textsuperscript{13}. Against this backdrop, care should be taken to ensure that any measures taken do not hamper the ability of banks to maintain solid capital bases, which are required to ensure the smooth transmission of monetary policy.

5. Financial stability considerations

5.1 The implementation of the draft law is expected to entail financial costs for the Latvian banking sector. The consulting authority has not submitted an explanatory memorandum containing an impact assessment regarding the profitability, capitalisation and future lending capacity of the banking sector.

5.2 The draft law emphasises that rising mortgage loan payments and the rising cost of living put pressure on household balance sheets. Requiring banks to partially reimburse loan interest payments to borrowers whose cost burden has significantly increased can support financial stability by mitigating credit risk, for example, by allowing borrowers to recover from temporary liquidity shortages. However, the eligibility criteria laid down in the draft law do not sufficiently limit the scope of borrowers entitled to a reduction in mortgage loan interest payments as the draft law will impact the majority of outstanding mortgages. In addition, while it is estimated that around 13\% of borrowers in Latvia could face financial strain due to rising prices and interest rates, the impact of interest rate rises on the overall solvency of households will be moderate and the larger effect is expected to come from consumer price surges\textsuperscript{14}, potentially limiting the desired effect of the draft law. Historically low non-performing loan rates across Latvian banks also challenge the justification of the draft law.

5.3 The widespread and untargeted reduction in effective loan interest payments that adoption of the draft law is envisaged to achieve could give rise to financial stability concerns. Bank profitability will be unduly lowered if borrowers who are able to make payments benefit from the compensation fee\textsuperscript{15}. Reduced bank profitability implies a lower capacity for banks to retain earnings and thus may reduce capital available to credit institutions. Beyond reducing bank resilience, this could have adverse effects on bank credit supply. The lower profitability resulting from the application of the draft law could push banks to offer less favourable credit terms and increase lending rates, and may lead to lower credit supply, which can then adversely affect real economic growth.

5.4 The resulting lower profitability and capital would reduce credit institutions’ capacity to build up extra capital buffers to protect them against future economic shocks. This is especially the case considering that Latvia is in the process of implementing a special corporate income tax regime for credit institutions, frontloading the tax payment without waiting for the profit distribution. This particular measure should not, however, have an impact on the total amount of tax paid by credit institutions, as taxes already paid will be discounted from taxes to be paid after the profit distribution.

\textsuperscript{13} See paragraph 3.4 of Opinion CON/2023/26 and paragraph 3.4 of Opinion CON/2023/35.

\textsuperscript{14} See Appendix 2 (‘Borrowers’ ability to withstand rises in costs and interest rates’) of Latvijas Banka’s Financial Stability Report 2023, available on Latvijas Banka’s website at www.bank.lv.

\textsuperscript{15} See paragraph 3.3 of Opinion CON/2023/8.
5.5 The fee proposed in the draft law may also lead to fragmentation in the domestic and European financial system because of the heterogeneous nature of the banking sector. This would particularly be the case where reliance on mortgage interest income for some credit institutions is relatively high compared to other activities. Furthermore, the draft law could distort market competition and impair the level playing field across the banking union.

5.6 The draft law may generate additional unintended consequences with negative implications for financial stability. Domestic and foreign investors could have less appetite to invest in Latvian credit institutions, as adoption of the draft law would lower the profitability outlook of credit institutions.

5.7 In the light of the above, the ECB recommends that the draft law is complemented by a thorough analysis of the potential negative consequences for the banking sector. The analysis should detail the specific impact of the proposed fee on (1) the provision of new lending and (2) competition conditions in the market.

6. Considerations relating to the prudential supervision of credit institutions

6.1 The ECB understands that the draft law would apply to significant credit institutions directly supervised by the ECB and less significant credit institutions directly supervised by national competent authorities under the oversight of the ECB within the framework of the Single Supervisory Mechanism.

6.2 It is also the ECB’s understanding that the basis on which the proposed fee would be established does not take into consideration, inter alia, the full business cycle and the cost of credit risk, as it is being computed based on balances instead of profitability. Moreover, the draft law would result in additional operational burdens and costs given the need to administer the fee calculation.

This opinion will be published on EUR-Lex.

Done at Frankfurt am Main, 11 December 2023

[signed]

The President of the ECB
Christine LAGARDE

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16 See paragraph 3.5 of Opinion CON/2023/9.
18 See paragraph 3.3 of Opinion CON/2023/9.
19 See paragraph 3.4 of Opinion CON/2022/36 and paragraph 3.7 of Opinion CON/2023/9.