Restructuring Housing Finance in Hungary

by Douglas B Diamond

The state of housing finance in Hungary mirrors that of the general economy. It is half transformed, both far removed from the old non-market, heavily subsidized sector under Communism and yet still with far to go to achieve the full benefits of the efficient, market-responsive systems such as in Western Europe or the U.S.. In 1994, Hungary will embark upon a multi-phase process designed to help close the remaining gap, with the support of both USAID-sponsored technical assistance and Housing Guaranty loan funds. This article describes the current situation of housing finance in Hungary and the new directions contemplated for the near future.

MACROECONOMIC CONTEXT

Economic reform has a longer history in Hungary than in other formerly socialist countries. Beginning with the New Economic Mechanism in 1968, a number of substantial reform measures were introduced over the last 25 years which had resulted in significant progress towards the transition to a market system even before 1989. By 1992, the private sector accounted for 44 percent of GDP, compared with 31 percent in 1988. The private sector contribution to GDP is expected to increase to above 50 percent by 1994.

The economic transformation process in Hungary has not been without many dislocations. Over the last three years, the Hungarian economy has suffered from a decline in total output, rising unemployment, high inflation, and a large budget deficit. Unemployment grew by 63 percent in 1992 and since then has stabilized at about 12 percent of the total labor force.

As in other Eastern European countries, inflation has remained persistently high throughout the recent recession and has had a severe negative impact on the Hungarian economy. Inflation, as measured by the consumer price index, rose from 17 percent in 1989 to 29 percent in 1990 and peaked at 35 percent in 1991. The rise in the consumer price level has been slower in 1992 and 1993, but is still over 20 percent.[1] Real wages are falling in most sectors. As a result of inflation and the large budget deficit, nominal interest rates in Hungary have been high, although at times inflation has exceeded market interest rates, resulting in negative real returns. During 1992, domestic interest rates on bank loans and deposits fell and that trend continued until mid-year 1993, after which rates rose sharply again.

THE HUNGARIAN HOUSING FINANCE SECTOR

As of the end of 1992, the Hungarian financial sector consisted of 29 commercial banks and 5 specialized financial institutions, excluding institutions in liquidation or receivership; 258 savings cooperatives; 13 insurance companies; and 25 securities brokerage firms. Despite the comparatively large number of financial services firms in operation in Hungary, there is a high degree of concentration in the sector. The four largest Hungarian banks hold two-thirds of all domestic bank assets and the two largest insurance companies account for 62 percent of the net income of the insurance industry. Cross-shareholdings among financial sector firms increase concentration in the financial sector even further.

Despite the progress which has been made towards the development of an efficient and competitive financial sector in Hungary, a number of areas remain which will require further reform and rationalization. The Government continues to hold large ownership positions in the largest domestic financial firms. As of the end of 1991, the state directly or indirectly, through state-owned enterprises and joint stock companies, owned 68 percent of the share capital of all

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domestic commercial banks and specialized financial institutions. Approximately 17 percent of total share capital was owned by private investors and 15 percent by foreign investors. As part of its overall privatization program, the Government is scheduled to phase out its ownership of financial institutions.

As in other centrally-planned economies, the state established one primary savings bank to channel the financial savings of the public into the rest of the financial system. These institutions also were generally the only source of consumer lending, including housing loans. Thus, today, the state-owned National Savings and Commercial Bank (OTP) currently dominates the housing finance market in Hungary. OTP originates over 90 percent of all housing loans in the country. The only other housing lenders are the 258 savings cooperatives, which have very limited housing finance activity concentrated primarily in the markets outside Budapest. There are only limited prospects for entry into the housing finance market either among the commercial banks created from the Hungarian National Bank ("MNB") in 1987, the international joint venture banks or the Hungarian banks which have been established since the liberalization of the banking laws. Other private financial institutions traditionally involved in housing finance, like insurance companies and pension funds, are still in their infancy and are unlikely to play a major role in the housing finance market for some time to come.

Meanwhile, OTP is funding its mortgage lending out of primarily short-term deposits. This would not be a problem if its deposit base were stable or growing in real terms. But, instead, the real deposit base has been eroding somewhat as other banks have entered the household deposit market and as households have shifted savings into foreign exchange accounts. Most banks, including OTP, also have experienced an erosion of capital as commercial loans have gone bad. To compensate, it appears that OTP has expanded its profit margin on mortgage lending.

Another shortcoming of the Hungarian financial system is the lack of truly long-term funds. In fact, bond issuances with a term of over three years are considered to be "long-term" and no issuance has been for more than seven years. This is partly because of the great uncertainty about future inflation, but also reflects the lack of investors for whom short-term liquidity is not a paramount concern. Such investors are beginning to emerge, especially in the insurance business and the private pension funds which will replace government pensions as more firms are privatized. These institutional investors will seek longer-term, high quality investments which will earn higher yields than those offered on government bonds. The development of this institutional investor market should result in a stable flow of funds into the capital markets and create the potential for the mobilization of longer term financial resources for housing finance.

Hungary was different from most centrally-planned economies with respect to the availability of housing finance. The Communist government preferred to encourage individual ownership of housing and provided limited amounts of financing at fixed below market rates to facilitate home-ownership. These subsidies were reduced and revised in 1989. They became a phased-out buydown of a certain percentage of the repayment amount, based on a variable "market" rate loan. Because inflation has remained high, interest rates have remained high. The real value of the subsidy element has been higher than expected because the interest rates in the early years of the loans have been higher than expected.

The current crisis level of budget deficits makes reductions in these subsidies mandatory. This has already occurred to some extent because the amount of loan on which subsidies are available has shrunk significantly as a share of house prices and few can afford to borrow much additional funds at the full market rate (28 percent). Most bank loans are now only for 25-40 percent of the value of the house, despite the deep subsidies.

CREDIT RISKS

Credit risks are high because of rising unemployment and declining real wages, problems which can only be resolved by the transformation of the Hungarian economy. However, there are some problems which are peculiar to the housing finance sector. These include:

- *The unenforceability of the mortgage against the property being financed.* The limited ability of the lender to enforce a residential mortgage through foreclosure and sale presents a risk no totally private lender will be willing to accept, at least not in the current social, economic, and political circumstances in Hungary. For example, over 3.5 percent of the OTP mortgage portfolio is delinquent over one year, yet there is little that OTP can do to collect on these loans. The problem of mortgage enforceability is compounded by the provisions of the Civil Code relating to the priority of claims against debtors under which the mortgage lender is not given a first right to the proceeds realized from the sale of the property.

- *The lack of mortgage loan underwriting and servicing procedures appropriate to a market economic system.* In addition to the problem of unenforceability of mortgages through effective foreclosure and eviction procedures, credit risk includes risks associated with accurate underwriting of the borrower and the home and effective servicing and management of the loan. Current underwriting and servicing procedures along with the current status of industries supporting housing finance such as appraisal and credit information need to be improved upon to address market risks. Declining real wages and increasing unemployment plus changes in the way OTP can respond to delinquent borrowers make housing lending even riskier. To manage this changing environment, stronger underwriting

Figure 1 : Deferred Payment Mortgage

The Deferred Payment Mortgage (DPM) is a standard variable rate mortgage with partial capitalization of the contractual interest due. The amount of interest capitalized is the difference in the full payment due under the contractual interest rate and that due at a lower "payment" interest rate. At the end of each month, year, or other period, the payment stream is recast to amortize over the remaining term.

Both the Price-Indexed mortgage and the Dual-Index mortgage are special cases of the DPM. For example, if the payment rate is set at some fixed real interest rate and the contract rate is the real rate plus inflation, the DPM is simply a price-indexed mortgage. But, in general, the DPM has the advantage of not relying on statistical indexes and being more easily understood by the borrower. Moreover, the degree of "tilt" to the expected real payment stream can be varied to reflect the macroeconomic risks in the country, by simply raising the premium in the payment interest rate over real interest rates.

and servicing procedures are needed so that lenders can better originate and manage loans to minimize risk in a market system.

ADDRESSING THE CONSTRAINTS

The situation poses some difficult challenges for policymaking for the sector. The sector needs private ownership and real competition in the longer run, but the economy needs the immediate stimulus of increased housing lending by the monopoly lender, OTP. OTP needs technical assistance to reduce its operating costs and to improve underwriting and servicing, but this will make it harder for new entrants to compete with OTP. The Government needs to reduce the budget deficit, but continuing inflation is keeping the reliance on subsidies high and eroding the incentive value of existing subsidies. More long-term funds are needed to reduce liquidity risks, but credit risks must be made more manageable before long-term investors can consider providing funds.

The Government of Hungary, with technical assistance from USAID, has formulated a plan to gradually restructure the housing finance sector so as to deal with all of these concerns. This program attempts to encourage and facilitate the step-by-step transformation of the housing finance system towards greater efficiency and effectiveness, lower subsidy, and greater competition. Specifically, the program would:

- Encourage the adoption of a deferred-payment type of mortgage (see box on the DPM) that permits the reduction and eventual elimination of mortgage repayment subsidies;
- Encourage the reduction and reallocation of credit risk, so as to facilitate the entry by competing originators and servicers;
- Encourage the creation of a secondary funding mechanism, that would permit the substitution of institutional funding for deposit based funding.

In each phase of the program, USAID-sponsored Housing Guaranty loans to the Government of Hungary would be on-lent to participating lenders who originated DPMs. The HG funding is relatively small compared with the overall level of housing lending, but it is extremely long-term compared with any other source of funds. It can also serve as a major portion of funding for new entrants just experimenting with such consumer lending.

The program also includes a very substantial component of on-going technical assistance on key aspects of the reform effort, including implementing the DPM, improving underwriting and collections, strengthening access to the collateral, and developing mortgage insurance and secondary market programs.

The program encompasses at least three phases over three years or more. Each phase includes steps in each of these policy areas. The first phase involves the adoption of a reduction by the government of the repayment subsidies currently in place and extensive technical assistance to OTP and any other interested lender towards introducing the deferred-interest type of mortgage. In addition, the government would set-up an internal working group to identify the best approach to strengthening the ability of lenders to recover on defaulted loans.

The second phase would involve selection and implementation of steps needed to reduce credit risk. Having done so, the government would work towards developing a secondary market (primarily to serve as a liquidity mechanism for banks). As a part of that, the government would consider developing a risk-sharing mechanism to buffer lenders and investors against severe economic shock.

The third phase would involve implementation of the risk-sharing program and further development of a secondary market mechanism. At the end of this phase, it is expected that the conditions will have been met for easier entry by private sector entities, including possibly by mortgage bankers. During the program, OTP may receive the bulk of the on-lending under the Housing Guaranty loan, but other entrants would be eligible for technical assistance to prepare themselves for lending and for refinance as they actually originate eligible loans.

The program has been designed backwards from the desired end-point, guided by the desire to create a competitive and efficient housing finance system. Although this can only be done by having institutional and legal infrastructure supportive of such a system, providing that infrastructure may not be sufficient for a prompt response from such a fledgling private financial market as in Hungary. Forcing the system through direct or indirect subsidy or intervention, however, could create new long-term distortions in the overall financial system. The program is flexible and open-ended and will evolve as the economy, financial markets, and political situation evolves. ■