PN-ACJ-580

CONSTRUCTION FINANCE IN HUNGARY:

MARKET OUTLOOK

Prepared for:

USAID

East European Regional Housing Sector Assistance Project
Project 180-0034
U.S. Agency for International Development, ENI/DG/LGUD
Contract No. EPE-C-00-95-001100-00, RFS No. 555

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November 1998
UI Project 06610-555

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INTRODUCTION

In Hungary, as in other Central European countries, the change from command to market economy and to a market-oriented housing system led to sharp decrease of new construction. The substantial decline of output creates growing difficulties in the housing system. This can be considered a "normal" consequence, on the one hand, of the relatively good housing situation of these countries compared to other countries with similar GDP/capita level, and, on the other, of the high level of inflation and low level of solvent demand of the population.

The problem in the new residential construction sector lies much more in the fact that, contrary to expectations towards market-oriented systems, the roles of bank financing is decreasing. This is true on the buyers' side (the share of loans within the price of the new units decreased from 31 percent in 1989 to 14 percent in 1998), while bank financing plays only very small role on the developers' side, as well. Therefore in many cases not even those construction projects can be realized which would correspond to the given circumstances on the local market.

Without addressing in detail with the role of the local governments, who in many cases go with their requirements well beyond their original role, which is to ensure the enforcement of local and central building regulations, the main problem of developer financing is the lack of skill, confidence on part of many banks - leads to high equity requirement, high collateral requirement, poor lending decisions and number of other results that are counterproductive to the growth construction financing. Only a few developers can satisfy these requirements and these are in most cases not the smaller firms but large developers with enough reserves to be able to provide the collateral.

In this paper we analyze the main reasons for the very cautious behavior of most banks in lending to developers. Basic information for the paper comes from USAID sponsored training courses given for developers and bankers and from surveys and interviews.

The structure of the paper is as follows. We begin with an overview of housing construction in Hungary since the beginning of the transition, to provide a backdrop on the market for construction finance. This chapter concludes with a look into the future, noting especially the variables that will affect the market. The following chapter comes to the heart of the paper: assessing the outlook for development finance in Hungary. Starting with a look at current sources for financing and funding, the chapter then turns to the mechanics of development lending. This section includes the perspective of both developers and bankers, and identifies weaknesses and especially thorny problems identified from both sides. The chapter concludes with a summary of the key outstanding issues and possible remedies that can be undertaken by developers, the government, and the banks themselves, in order to pave the way for a more vibrant and profitable market for effective construction finance. A brief conclusion closes the paper with a summary of the market's potential and the principal action areas.

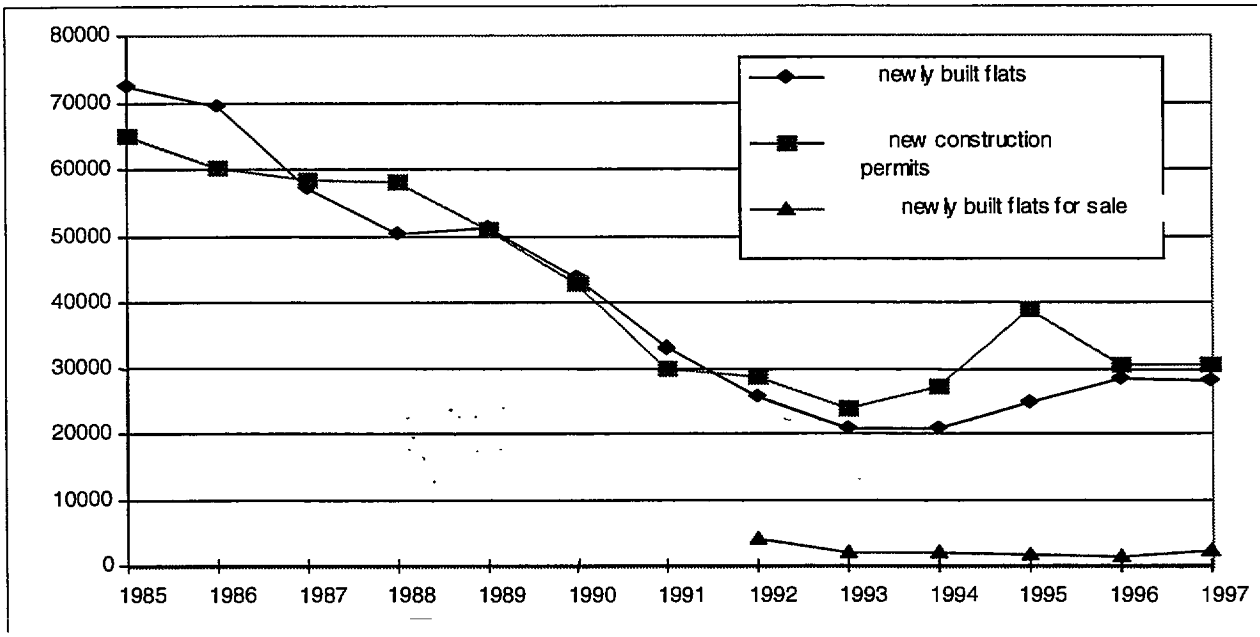
HOUSING CONSTRUCTION: THE POTENTIAL MARKET

Background: 1990-1993

■ **Volume.** In Hungary, the total number of housing flats built in 1990 was 43,770, an extremely low level compared to the previous nine years (1981-1989) when the average construction level was 66,500. And the downward trend continued: by far the highest volume of new housing construction during this decade occurred toward the end of the socialist system in 1990 and 1991. New housing construction did not approach these levels during 1992 and 1993 when the average new construction volume was 40 percent less than the average volume during 1990 and 1991. It is fair to state that the country's movement to a market economy brought about significant reductions in housing construction from the high levels realized during the preceding years.

The number of new construction housing units occupied was about equal to the number of new construction permits issued from 1990 to 1993. In periods of high demand, the volume of new construction permits will normally overtake occupancy levels as builder's "gear up" to meet higher demand. On the other hand, 1990-1993 data would suggest that builders expected a flat market, not unreasonable given the significant reduction of housing construction in 1992 and 1993. However, it may also reflect other factors such as obstacles to obtain the necessary government approvals (not to mention financing and professional services) in order to obtain new construction permits. In fact, one report indicates that the early 1990s were characterized by lengthy and delayed construction schedules, which would tend to discourage aggressive construction planning.

Figure 1
Number of newly built flats, new construction permits and new flats or sale between 1985 and 1997



Source: CSO Housing Statistics Bulletins 1990-1996

Table 1
Number of new flats between 1990 and 1993

Year	Number of flats
1990	43,770
1991	33,164
1992	25,807
1993	20,925
Totals	123,666

Source: CSO Housing Statistics Bulletins 1990-1996

■ **Market:** A large majority of the builders were natural persons (most of them are individual households), 80 percent in 1992 and 87 percent in 1993. Enterprises represent the second largest group with 17 percent and 11 percent of the market in 1992 and 1993, respectively. A small percentage of the housing units were built for sale - 15 percent in 1992 and 10 percent in 1993. Of the 20,925 housing flats constructed in 1993, 17 percent were located in the capital, 41 percent in towns and 42 percent in the villages. A similar pattern is clear for new construction permits in 1993, 15 percent for Budapest, 40 percent for towns and 45 percent for villages.

■ **Size and Utilities:** During the early 1990s, the national tendency favored larger floor areas each year. In 1993 the more spacious flats had been built in the towns and villages compared to the capital where the cost of real estate and labor was usually higher. The construction in the early 1990s was known for centrally sourced heating, but more than 75 percent of it was central but not district heating system (e.g., individual central heating system).

■ **Financing Sources:** Of the 43,770 housing units constructed in 1990, subsidized loans were used to finance 31,290 or roughly 72 percent while business enterprises self-financed about 20 percent of the units and 8 percent was generated from other sources. The overwhelming majority of government loans in 1990 was used to finance the construction of 30,574 flats for households (this number shows the amount of the so-called self-help housing construction).

Next Phase of Development: 1994-1997

■ **Volume***:* Following a flat year in 1994, housing construction returned to higher levels during the next three years. The average volume in 1996 and 1997 was almost 20 percent higher than the average volume during the previous two years. Why? One reason proposed by housing experts involves "social-political measures" after 1994, which led to real increases in down payment subsidies (formerly the "Social Policy Allowance" and renamed the "Housing Construction Allowance" in November 1994). The same reason is cited for the large increase in new housing permits in 1995 (39,000) which was the largest number recorded between 1990 and 1997. Aside from the increased subsidy allowances, the country's economy improved as the national unemployment rate declined and Gross Domestic Product (GDP) improved from the negative growth rates experienced from 1990 to 1993:

Table 2
GDP and Unemployment rate in Hungary between 1991 and 1996

Year	GDP (1990 Prices) HUF Billion	Unemployment Rate
1991	1,840.7*	
1992	1,784.4	
1993	1,774.1	11.9
1994	1,826.4	10.7
1995	1,853.6	10.2
1996	N/A	9.9

* Decrease of 11.9 percent from 1990.
Source - IMF Statistics, August 1998.

It is interesting to note that 1997 was the first time in four years that housing suffered a negative growth rate, although a modest decrease in absolute terms from 1996. Furthermore, the number of housing units occupied in 1996 and 1997 was about equal to the number of new construction permits (similar to the relationship that existed during the early 1990s).

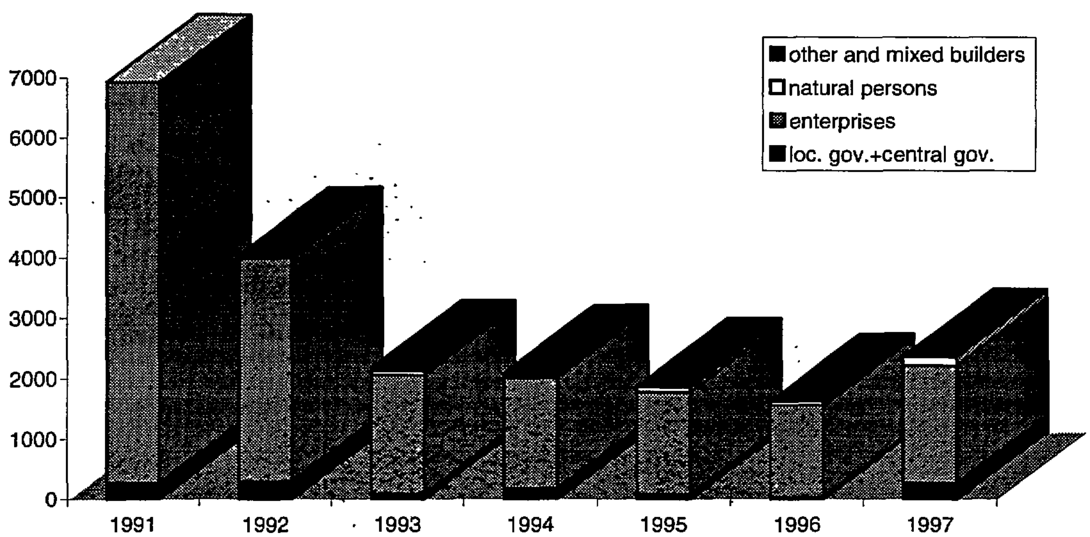
Table 2
Number of new flats between 1994 and 1997

Year	Number of flats
1994	20,947
1995	24,718
1996	28,257
1997	28,130
Totals	102,052

Source: CSO Housing Statistics Bulletins 1990-1996

■ **Market:** Natural persons continued to dominate the market by building 86 percent of the housing units in 1994, 91 percent in 1995 and 92 percent in 1996. The number of units built for sale was 9 percent in 1994 and 7.2 percent in 1995, the fourth consecutive annual decline in this category. However, in 1997 the number and proportion of flats constructed for sale purposes were higher, especially in Budapest and the five other cities with “county rights”.

Figure 1 Number of new flats for sale between 1991 and 1997, by type of builders



Source: CSO Housing Statistics Bulletins 1990-1996

The regional distribution of housing construction continued to grow in the villages, as did the number of new construction permits in 1996-1997. Since 1994, Budapest has moved from the first to the third position in terms of the number of flats constructed. In 1996-97, County Pest took over the first position and County Szabolcs-

Szatmar-Bereg claimed the second position[1]. A favorable development in terms of housing construction and market opportunities has occurred with the significant reduction of "checking time" (time elapsed between release of the construction permit and the move-in day).

Table 4
Housing construction in Budapest in 1998

District	New flats that are being built	of which, those that can still be purchased	Average prices, HUF/sq.m.
I.	34	14	200,000
II.	121	84	252,000
III.	190	99	185,000
IV.	335	84	115,000
V.-VIII.	N/A	N/A	N/A
IX.	206	107	135,000
X.	14	5	100,000
XI.	222	75	195,000
XII.	149	65	264,000
XIII.	149	60	115,000
XIV.	354	210	130,000
XV.	N/A	N/A	N/A
XVI.	50	42	115,000
XVII.	N/A	N/A	N/A
XVIII.	70	70	115,000
XIX.	36	22	112,000
XX-XXI.	N/A	N/A	N/A
XXII.	57	37	180,000
XXIII.	N/A	N/A	N/A
Total	1987	974	*158,052/159,011

Source: MARECO Ingatlan Rt., (Anna Szalai: Sought, but few the newly built flats-Second Rose Hill are being built in Szechenyi hill, in: Népszabadság, 08/05/1998)

*First number shows the average price of those, which are being built, the second the average prices which can be bought.

More specific construction information is available for 1997. A large majority of new residential development consisted of buildings with one flat on one floor indicating a low level of multifamily development. 75 percent of the flats constructed in 1977 can be found in areas with terraced houses and multi-family buildings.

[1] The number of newly built flats can be significantly modified in County Szabolcs-Szatmar-Bereg regarding that probably this county is one of most involved in the series of swindles connecting to 'Housing Construction Allowance'.

■ **Size and Utilities:** During 1994 and 1995, the average living space of the housing units was growing in the capital and in the villages. Since 1995, larger flats are being constructed on average in the capital and smaller units are being constructed in the villages. The latest figures for 1997 show that overall housing construction favors flats having 1.5 - 3 rooms as the construction of smaller flats (1 room) and larger flats (over 3 rooms) has decreased from prior years. The national average living area has declined with the exception of the larger flats. Moreover, national surveys have disclosed some unfavorable tendencies regarding heating for new housing. Since 1995, more households are generating their own heating supply (individual heating in each room), using solid fuels and moving away from centralized heating.

During 1996 and 1997, 93 percent of the flats were supplied with conduit water, 42 percent were connected with public sewage and 64 percent connected with a conduit gas supply system. Nearly 20 percent of the flats have at least one full bathroom with another smaller bathroom containing a shower or bath basin. More than 25 percent have independent heating systems, a much higher proportion than was recorded between 1985-1990. 94 percent of the flats have been constructed with bricks and concrete walls.

■ **Financing Sources.** In preparation for this paper, USAID undertook a survey of 24 banks involved or interested in developer financing. Nine of the banks responded with sufficiently completed questionnaires2. The following table summarizes the results of lending activity during 1996-1997:

Table 3
Survey Findings on Construction Finance

Question	Statistics	Data
Amount of total developer loans made from January 1, 1996 to December 31, 1997.		HUF million
	Average	1,450
	Maximum	3,000
	Minimum	500
	N/A (number of cases)	7
Subsidy/Interest Rate		
Percentage of amount of total loans made during last two-year periods that were interest subsidized loans.		Percentage
	Average	84
	Maximum	100
	Minimum	10*
	N/A	7
Annual gross interest rate charged on developer loans.		Percentage
	Average	26
	Maximum	28
	Minimum	24
	N/A	5

[2] It means that it is not representative survey, representing opinions of all banks that are interested in construction period loans. In some cases we got less than nine answers.

Question	Statistics	Data
Terms/Underwriting		
Normal maturity period.		Years
	Average	1.1
	Maximum	1.5
	Minimum	1
	N/A	6
Main underwriting considerations in order of importance.		—Risks —The size of the collateral —The feasibility study of the project —Prospects for profit
	N/A	8
Strategy		
Number of banks that want to expand developer lending.		Percentage
		67
	N/A	6

* Relatively low percentage as one bank reported activity for only one branch.

Comparisons: 1990-1993 and 1994-1997

■ **Volume:** The first four years of 1990 recorded the building of nearly 22,000 more housing units compared to the next four years. Although trends started to move favorably in 1995 and 1996, growth in 1997 was negative compared to 1996? The relationship between the number of housing units occupied and the number of new construction permits is similar for 1990-1993 and 1996-1997. Aggressive building plans were not apparent in the early 1990s and not apparent in 1996 and 1997, despite recent improvement in "checking time" and other information that indicates shorter construction periods.

Table 4
Number of new flats between 1990 and 1997

Year	Number of flats	Year	Number of flats
1990	43,770	1994	20,947
1991	33,164	1995	24,718
1992	25,807	1996	28,257
1993	20,925	1997	28,130
Totals	123,666	Totals	102,052

Source: CSO Housing Statistics Bulletins 1990-1996

■ **Market:** Natural persons dominated the construction market throughout the entire period with the percentage increasing steadily from 80 percent in 1992 to 92 percent in 1996. Consequently, the number of units built for sale consistently declined from 15 percent in 1992 to 7.2 percent in 1995. This trend appears to be changing as the 1997 percentage is higher than 1995. Clearly, new market opportunities for residential construction emerged in towns and villages based on the regional distribution of sales and construction permits, particularly in 1996 and 1997. Budapest continues to be a strong performer along with other cities possessing "county rights" and the latest figures show County Pest and County Szabolcs-Szatmar-Bereg overtaking the capital in terms of growth.

Consumer buying trends are more clearly defined since 1997 market information affords more details in terms of the utilities, amenities and consumer preferences compared to the information reviewed for prior years. The number and proportion of flats constructed for sale purposes have become higher in 1996 and 1997 and interest in upgrading housing appears to be growing under the new government.

▪ **Size and Utilities:** The average size of housing units has followed no set pattern although the latest information generally indicates flats with more rooms but less living space for the middle to lower level consumers. Access to public utilities has improved but a significant trend for self-contained heating systems has developed.

▪ **Financing Sources:** After substantial usage of housing subsidies to generate housing sales in 1995 and 1996, the pool of users has not grow significantly. One expert reports that the current subsidy system discourages growth to include either the more needy buyers or the wealthier buyers. The logic suggests that the needy, who have not already taken advantage of the subsidy, lack the minimal private resources, whereas the wealthier buyers are prevented by the rules from constructing the kind of housing they desire.

Shorter construction periods have been realized in recent years compared to the longer periods noted during the early 1990s. Normally, shorter construction periods enhance financing options, as banks prefer short term maturates for real estate construction loans.

▪ **Self-help Construction:** One of the dominant trends throughout this period is the self-help phenomenon: the almost complete absence of professional residential developers as significant market participants. Aside from a lower output, self-help construction has several other effects - notably, construction is slower, tying up capital for longer periods, and the finished product is of lower quality. Moreover, many homebuilders find the experience to be more arduous and costly than expected. One additional important feature is that self-help housing can more easily employ cheaper gray market labor, thus avoiding tax payments; making it difficult for firms to compete on price.

The reasons for this feature of Hungarian construction are complex, but many of them are related to finance: homeowners believe building on their own will be cheaper, and because it will be carried out in stages, will be easier to finance from savings, own income, and informal loans. They may also not be able to come up with the advance payments that developers typically require because of their own inability to obtain construction finance.

Future Outlook

Typically, a trade association of homebuilders and developers will develop projections to assist its members. This information is important for the planning and development of future projects (purchasing land, ordering materials, subcontracting for services, obtaining government permits, etc.) In the US, the National Association of HomeBuilders (NAHB) will perform this function for its members.

According to the NAHB, the factors most likely to influence demand projections for housing (and the availability of financing) in the *short term* include:

- Household Income–More than any other factor, consumers and lending institutions rely on past, present and near future income levels to determine the consumer affordability. Therefore, the trend of national and local income levels are a key indication for forecasting new housing demand. Conventional finance lenders will typically require evidence of steadily increasing income levels for the two to three previous years and evidence of income for the current year. Underwriting requirements are higher for self-employed individuals, for individuals with fluctuating income levels and or sources of income that are not considered dependable.

- Employment Rate–The rate of employment is a broad economic indicator for the housing market. Aside from a relatively few wealthy buyers, a very high percentage of homebuyers rely on employment from one or more members of the household to purchase and maintain the housing unit. Normally, projecting a healthy economy (for example Gross Domestic Product {GDP}) will translate into healthy employment rate predictions.

- While lenders will focus more on employment rates for consumer products (individual financing flats, cars, and personal needs), developer financing is tied closely to employment projections because of its importance to the housing market.

- Government Assistance Programs /Subsidy–Most countries have some form of government assistance or subsidy to support the housing industry. For example, the US allows the deduction from taxable income of interest payments on home loans and state property taxes. Projecting the expansion or contraction of these programs can have substantial effects on projecting the demand for housing depending on the citizens' need for such programs. In the US, there is heavy reliance on the home interest subsidy to purchase and finance a home. Therefore, if the home interest subsidy in the US is going to be phased out during the next five years (as threatened by some lawmakers), the future projection of home buyers, particularly first time buyers, would be reduced. Furthermore, the banks would analyze loan requests from developers and homebuyers using different models since disposable income would change for most leveraged homeowners.

- Inflation–Generally, too much demand in an under-supplied market produces increasing real estate prices and projections of similar activity. Projecting the *rate* of inflation in the housing market allows analysts to estimate "real growth" (or non-growth) situations. Obviously, countries with high inflationary tendencies require careful analysis to determine the net effect on the market. For example, it is possible to project increases in the housing sector of 5 percent for next year and, at the same time, expect inflation of 10 percent for a real growth rate of–5 percent (minus 5 percent). During periods of inflation, real estate values are increasing and are projected to increase (many times at unrealistic levels). Periods of high inflation often lead to a "hot market" where bank-underwriting standards are de-emphasized and real estate collateral appreciates, even as the developers seek financing and complete projects.

- Interest Rates–With few exceptions, the existence and projection of high interest rates has a chilling effect on economic investment as rates of return increase accordingly for potential investors and borrowers. The opposite movement of interest rates generally has a positive influence. The housing market is particularly sensitive to the movement of interest rates. Before pricing a loan to a developer, lenders must first determine their cost of funds and then add a profit margin that will provide a fair return given the anticipated risks. Therefore, in an environment where interest rates are increasing and are projected to increase thereby discouraging future home sales, developer loans are more expensive and tighter loan conditions generally apply (higher cash flow /collateral requirements, shorter maturity, etc.).

The factors most likely to influence demand projections and the availability of financing in the *long term* include:

— Population Demographics
— What are the age demographics?
— What age do people purchase houses?
— Is immigration a factor?

Most of the short and long term factors stated above could be used to perform housing projections for Hungary. In addition to these factors certain specific factors could be considered:

- How adequate or inadequate is the current housing stock?

- What portion of the current stock is not suitable for habitation?

- What portion of the current stock will be lost to development (demolished)?

- Are certain buyer groups more or less debt adverse regarding housing finance?

- Will certain buyer groups require less financing because of more resources/savings than other groups? How will this information affect demand estimates, buyer markets and financing needs?

- Other Market Considerations, i.e., is the pace of holiday home construction likely to continue?

Importantly, what those interested in the market—developers and bankers—need to look at is not only an increase in current construction, but also the conversion of self-help construction into a professional industry, that is, a market for both developers and construction finance. That conversion, in turn, can be significantly encouraged by the availability of finance.

FUTURE OUTLOOK FOR DEVELOPMENT FINANCING

Financing and Funding

Let us assume that strong housing demand is projected for the future. Where will the financing come from to support housing development? This section will examine the possible sources of financing and the related funding issues.

Sources of Financing

Development financing will come from three general sources:

Developer Equity: Once cash equity is committed for a project, the cost of equity is normally much lower than the cost of debt financing, particularly during the construction period when the developer is most sensitive to cost levels. However, only the largest developers have adequate equity to self-finance projects and the absence of debt financing eliminates the advantages of leverage (using loans from other sources to increase investment yields on successful projects). Therefore, it is not likely that developer equity will represent a reliable or an attractive source of financing for the amounts that are required.

Loans from Domestic Financial Institutions including commercial banks (The Banks): While debt financing is more costly compared to developer equity during the construction period (25 percent-30 percent for HUF loans in September), the leverage factor for successful projects increases the yield potential. Moreover, the combined cash resources of the financial sector represents a more reliable source of financing to meet anticipated levels. Consequently, yield and volume factors favor debt financing from Banks.

If housing construction is to return to the levels higher than the current trend, loans from banks are essential particularly loans to finance developers during the construction period (construction loans). Construction loans allow developers to proceed with projects and bridge the time gap between cash expenditures to build projects and cash receipts from the sale of units in the projects. The time gap is the time that it takes to build and sell a project.

Loans from Foreign Banks: For the same reasons stated in 2 above, foreign banks are a potential source of financing. As foreign banks continue to buy and hold equity positions in domestic banks, this source of financing is likely to play a larger role.

Construction Finance Subsidy: In the case of Hungary there is one special subsidy form existing for developers, based on financial sources from the central budget: the interest rate subsidy of construction period loans. In principle, those developers who build housing for sale have access to this subsidized loan. The regulation of subsidy aims to create incentives for quick repayment of the loan: in the case of repayment within one year, the subsidy is 75 percent (for repayment between 1 and 2 years 60 percent, while for repayment between 2 and 3 years 25 percent) of the base interest rate plus 1.5 percentage points. This amount is paid from the budget to the bank, thus the developer has only to pay a much lower interest rate for the loan.

From the table attached it can be seen that the share and amount of construction period loan subsidy is planned to decrease for the coming years (the accurate numbers can be seen in Appendix). In the years 1997 and 1998 this subsidy was around 2 billion HUF/year, which means approximately 12-14 billion HUF total loan amounts. There are at least 15 commercial banks, which are active in lending for developers, and although OTP lends the most, its dominating position is far less strong then in the case of lending for buyers.

Table 5
Housing Subsidies in the Proposed 1999 Budget (in percentage)

	1995	1996	1997	1998	1999	2000	2001	2002
Subsidies related to the buyers:								
Housing construction allowance	53,1	54,3	55,5	50,8	43,6	40,4	37,1	34
Housing loan allowance	21,8	20,5	21,6	19,5	14,2	9,7	8,9	6,8
Subsidies related to the developer:								
Construction period loan subsidy	0,7	2,4	3,8	3,9	3,8	1,8	1,6	1,5
Other subsidy forms	24,4	22,8	19,1	25,8	38,4	48,1	53,2	57,7

	1995	1996	1997	1998	1999	2000	2001	2002
Total percent	100,0	100,0	100,0	100,0	100,0	100,0	100,0	100,0
Amount in billion HUF	68,3	58,9	53,2	51,2	52,8	56,9	61,5	66,2

Source: Proposal for the National Budget for Hungary, 1999 (Ministry of Finance)

The table clearly shows the intentions of the Government, while decreasing the subsidies for new construction both on the side of the buyer and of the developer, the share of the "other subsidy forms" is increasing, referring mainly to the increasing contribution to the functioning of the new housing savings banks (growing to more then 25 percent of all subsidies by the year 2000).

The construction period loan contains a quite attractive subsidy for developers. The fact that this has been underused so far shows the effect of the very high banker collateral requirements.

The foreseen decrease in this subsidy form is also supported by some of the experts, considering the fact that small and medium developers have little chance to get access to this subsidy at present, as it goes overwhelmingly to the larger firms. Given the knowledge that in most developed markets the small players dominate the residential construction field, this is a significant drawback. It may be that the future of this subsidy should be discussed in connection with the suggestions for improving the relationship between banks and developers. One approach might be to restructure the construction subsidy to make it less generous but to ensure wider access; in this way, instead of being used as an additional benefit for a few large firms, it could prime the pump to encourage participation in the sector by a much broader array of players. Both banks and developers, who project a substantial increase in the share of developer' built new houses for the next five and ten years, could benefit from such a change.

Funding Issues

Funding for developer equity will come from retained earnings (undisbursed profits) and money from investors. Raising money from investors will largely depend on the developer's confidence in a project, his salesmanship skills, investor preferences and alternative investments.

Funding for Bank loans will require access to reasonable and dependable sources such as deposits, the capital markets and government programs, which will involve various factors including:

- Maturity: In the past, depositors and investors have resisted the longer term instruments. Ideally, the Banks prefer long term funding sources because development financing requires long term loans (1-5 years).

- Pricing: Higher rates of return are required to compensate depositors and investors for longer maturities, which are, perceived as riskier instruments.

- Market Structure: Postabank, OTP and savings cooperatives have been collecting nearly 80 percent of household deposits which deprives other Banks of an important funding source.

- Government Policy: The willingness of the government to promote funding programs designed to allow the Banks to access adequate liquidity is dependent on the government's fiscal and monetary policies.

Funding—Positive Factors

Notwithstanding the funding issues facing the Banks, several positive points are important to note relating to the financial condition of the Banks and investor confidence:

- Following a painful reorganization of the financial sector in the early 1990s, the Banks have been improving their liquidity and capital positions, key components for determining financial strength. In fact, most banks exceed minimum capital requirements, which was not the case in the early 1990s.

- The rate of inflation is a major indicator of interest rates and Hungary's inflation rate has decreased from an annual rate of 28.3 percent in 1995 to 18.3 percent for 1997. Furthermore, Political Risk Services, an internationally respected rating service of sovereign risk, projects that the country's inflation rate will continue to decrease over the next 5 years, reaching 12 percent in 2003 (see attached Exhibit #). If so, interest rates should also decrease meaning lower cost of funds for Banks.

- Banks recognize the earning potential for development finance and appear anxious to learn ways to attract funding for development financing.

- Investor confidence in Hungary is strong which reflects favorably on investor/depositor confidence. Standard and Poors is an internationally respected investment rating service. As of September 2, 1998, S&P rates Hungary an A- for long term obligations, A-1 for short term (local currency outlook) and BBB for long term obligations and A-3 for short term (foreign currency); both the local and foreign currency outlook is rated "Positive". All of these ratings are considered "Investment Grade" or above and would allow Hungary to access the capital markets, if Banks needed more liquidity to fund development loans.

- Lastly, OTP is a known lender to Developers and its obligations are also rated Investment Grade, BBB, for long term/local currency obligations. This suggests that the Bank, in its present form, will continue to have direct access to the capital markets.

Development Lending by Banks

Assuming that strong housing demand is projected, and the Banks have sufficient funds to satisfy the loan demand, the question then becomes will the Banks make the loans? This question is examined from a historical, developer and banking perspective and possible solutions to lending issues are proposed.

Historical Perspective

The Banks, with the possible exception of OTP, have been reluctant to play a meaningful lending role with developers. The Banks' reluctance can be traced in part to conservative policies formed in the early 1990s:

- The Banks that survived the reorganization of the financial sector during the early 1990s emerged with weak loan portfolios. As part of the reorganization, minimum capital requirements were imposed which meant that the Banks could ill afford any further deterioration in loan quality.

- As part of the reorganization, the National Bank of Hungary transferred bad loan portfolios to the Banks. Emphasis was placed on conservative lending policies; lending was reserved for high quality, well known customers.

- Real Estate developers have defaulted on loan obligations. This reinforced the belief by most private bankers that development lending was very risky.

- Banks have been preoccupied with reorganization issues, raising capital and improving stock prices. The business environment has not been conducive to making loans to an industry perceived as new and risky.

A Developer Perspective

According to the developers that provided comments for this Paper, several factors exist that prevent Banks from actively lending to developers:

- Management and Organizational Issues:

  — Real Estate knowledge and experience is generally lacking at most Banks.

— Lack of knowledge and experience leads to a poor understanding of the market, the project lending process and the relevant risk factors.

— Few Banks have formed specialized real estate lending departments as a separate unit. When corporate, commercial and other lending activities are combined with real estate lending, important market knowledge and industry expertise are sacrificed.

— Few Banks have officers in branch locations trained in project lending and loan requests are sent on to other locations for analysis resulting in delay and poor service.

— Only the larger developers with experience and substantial cash equity are considered for project loans.

The above points are supported by Dr. Akos Balassa in his article regarding the restructuring of the Hungarian banking sector[3] which stated that the most overlooked requirement of the reorganization was a needed, radical improvement of management, organization and operations. Although most developers concede that this situation is understandable given the historical banking perspective, they believe that Banks should hire experienced real estate professionals and educate their staff now. If not, then the Banks risk losing customers and new market opportunities.

Technical Issues

The development and construction business is a complex process usually carried out in several stages. First, land is appraised and acquired, and, after approval from local officials, the land is cleared, graded and improved for development (roads, curbs, gutters, sewers, etc.) Next, housing units are constructed in accordance with plans, specifications and local building codes. Then, the housing units are sold (or leased) based on demand and availability of financing, after certification by local officials. Developers want their bankers to understand the development process, which requires technical and financial expertise. Thus, bank staff must be trained and acquire skills in:

- Appraisal methods, the municipal process for approving projects, engineering concepts involving architecture and construction, and other areas, and the use of trained consultants who are technically capable of assisting with development projects.

[3] Dr. Ákos Balassa, "Restructuring and Recent Situation of the Hungarian Banking Sector.", National Bank of Hungary NBH Workshop Studies 4,

Lending Policies

The management/organizational issues and the lack of technical training lead to the formation of unfavorable lending policies as Banks:

- Refuse to analyze the appropriate risk factors and therefore not participate as a project lender. Instead, the Banks direct their funds to other loans or investments that are perceived as less risky.

- Approve project loans without understanding the risks involved and repayment of the loans is left to chance. Many of these loans result in problems, which discourages future project lending.

- Will try to compensate for their lack of knowledge and experience by imposing unreasonable terms on the developer such as excess collateral requirements, reportedly 150 percent to 200 percent of the loan amount. In fact, many banks have been accused of refusing to count the project itself as collateral thus making collateral requirements more difficult for the developer. These collateral requirements fall especially hard on the smaller developer firms, which–it is important to note–most market economies make up the lion's share of the market.

A Banking Perspective

Bankers acknowledge that historical factors slowed the evolutionary process for development lending. However, other issues exist which help explain the banking sector's reluctance to become active project lenders:

■ **Profitability.** Banks must be convinced that project lending will be a profitable business before resources are invested in special lending groups, training, consultants and experts. While recognizing a duty to customers and the community to support housing development, the Banks are in the business of making a profit for shareholders. Profitability from project lending will depend on factors relating to the market and loan quality:

- The *market should be large and vibrant* for project lending to be profitable and not all of the bankers are persuaded by optimistic market predictions. Bankers fear that a flat or declining housing market will result in too many Banks chasing after too few project loans. Such a market would result in lower bank margins and lower loan requirements with diminishing profit potential.

- Banks know that profitability is impossible without making *high quality development loans.* A portfolio of poor quality loans will require Banks to forego income and establish reserves from income and capital. Banks realize that more market knowledge and experience is needed along with more access to information channels in order to properly evaluate projects. It takes time to accomplish these objectives.

- Based on the Banker Survey, an average of 47 percent of the developer loan requests are actually approved by the Banks (less than 50 percent). Lack of capital, lack of collateral and insufficient evidence that the units will be sold are the three major reasons given for not approving a loan. Consequently, Banks are developing *selective practices* involving *loan, collateral and equity requirements* designed to maximize human resources and reduce project lending risk. For example, most Banks will only consider project loans over a certain amount, generally around HUF 10 million. Furthermore, developers will not qualify for loans unless certain minimum equity and collateral requirements are met.

Unfinished Projects and Advance Payments

When a developer or builder is unable to complete a project, the major losers are the Bank along with unpaid suppliers and buyers that have tendered advance payments. Unfinished housing projects can be seen in most markets around Hungary (by no means unique in this regard) and are, probably more than any other single factor, the major contributor to unfavorable perceptions in the building industry. If a developer borrows money from a bank and is unable to complete a project, the bank must make a decision whether to:

- Leave the project unfinished and wait for another developer's offer to buy (usually at a high discount).

- Advance more funds to another developer to finish the project and allow for sales to proceed.

- Either prospect is unattractive for most projects and rarely results in a full recovery of loan proceeds for the Bank.

In many cases, the Bank's loss is accompanied by the loss of advanced payments made by buyers before the developer's problems become public information. In some mature housing markets, advance payments are put in an escrow or "blocked" account, out of reach of the developer and the bank. This arrangement allows for the payment to be returned to the buyer should the developer or project run into problems. Our research indicates that similar safety features are not promoted in Hungary. According to the Banker Survey:[4]

- Nearly 89 percent of the developers taking out loans take advance payments from buyers.

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[4] Number of cases is 7 or 8.

- The total of advance payments collected average over 31 percent of the total project costs (a significant portion).

- Over 60 percent of the time, banks are aware that the developers are collecting advance payments.

- 38 percent of the time, banks require collection of advance payments as a condition of the loan.

- The three most common uses of advance payments in their order of importance are to:

  — Pay for project costs
  — Repay the bank loan
  — Keep with the bank as collateral for the loan

Clearly, advance payments play a major role in financing housing development. Given the exposure of buyers and banks, adequate protection from unfinished projects and the losses that follow is a priority item for the industry to address.

Trust Factor

Plainly stated, Banks find it difficult to trust developers and, based on our discussions, developers have a similar view of the some banks that are active development lenders. Banks generally have assumed that bigger developers are probably the more trustworthy developers at least in terms of repaying loans. Moreover, Banks consider the larger and more experienced developers more likely to complete projects, an important consideration given the points raised in the prior sub-section and given the average construction time to complete housing projects (construction time for single unit projects have averaged 24-29 months in and around Budapest).

Without analyzing the historical differences between lender and borrower that led to trust problems, it may be helpful to summarize some common points of interest and reasons why both should work together:

- Shared Goals: Both banker and developer want the housing projects to be successful projects that enable the customer to realize profits (potential deposits for the bank) and repay loans, interest and fees (bank income).

- Teamwork Advantages: As developers consider projects (types of housing unit, related products, and location), the combined experience and skills of both developer and banker increase the likelihood of a successful outcome.

- Combined Front: Project development brings in many third parties, i.e., government officials, home buyers, long term lenders (to pay out the construction lender), etc. Favorable reactions from third parties are more likely when the bank and developer present a consistent message.

- Long Term Relations: Both bank and developer want and will benefit from a long-term affiliation. The bank wants the developer to grow and prosper which will increase the services and income opportunities for the bank. The customer wants a strong, safe Bank to handle deposits, payroll, cash management and investment accounts without interruption as long as the services are good and priced right.

Uncertainty

Bankers, as a rule, abhor uncertainty and resist loans characterized by unacceptable levels of uncertainty. Clearly, project lending and related regulations are relatively new and Banks are uncertain of the future real estate market and how it may affect project loans and compliance with regulations. Several examples will illustrate the point:

- One major Bank imposes strict cash collateral requirements for project loans in case the market value of real estate collateral should decline and additional reserves are needed. This practice results mainly from the Bank's lack of confidence in its own appraisal analysis.

- Several Banks have stated that accessing information on developers and their projects is difficult, which adds to uncertainty for approving a loan request. The general lack of information on developers is a big problem for Banks, particularly in this industry where many new developers are emerging.

- Finally, uncertainty can attach to a subsidized developer loan and may continue even after the loan is paid in full. Banks rely extensively on the information provided by the developer to qualify a project loan for a subsidy. The regulations can be interpreted in such a way as to allow the government to invalidate a subsidy at a later date and hold the Banks responsible for reimbursement, which could run into substantial amounts of money. Such uncertainty causes Banks to refuse loan requests or, again, require excess collateral from the developer until the risk of reimbursement is eliminated. Of the nine banks that participated in the Banker Survey, 96 percent of developer loans made in 1996 and 1997 were subsidized loans.

Financing Issues

Financing for the individual buyers of housing units (buyer financing) has been slow to gain widespread favor among lending institutions but is starting to develop and generate interest. Buyer financing represents the source of repayment for most development loans and is, therefore, an important factor for both the developers and the

Banks. Recent information and comments from the Banks have revealed two issues that affect the availability of buyer financing:

- Liquidity: Normally, the lenders of buyer financing expect to access liquidity through a secondary market or in the capital markets. In this way, buyer mortgage loans are bundled together and sold or used as collateral, and more cash is created for the lenders to extend more loans. While liquidity may not be an issue for OTP, it may be one for local banks that lack access to the capital markets or significant levels of household savings deposits. A healthy secondary market is more likely to emerge in Hungary when a large volume of well-secured and standardized loans is created.

- Mortgage Conflict: Bankers report that conflicts occur on projects (like condominium) where one lender holds the project as collateral and another lender is arranging financing for the buyer. Project lenders generally refuse to release their mortgage on units until the entire project is completed which works against a buyer that is trying to finance the purchase of an individual unit. Consequently, one Bank must act as both lender for the project and lender to the buyers to facilitate a smooth transition of collateral. Unfortunately, few Banks offer both kinds of financing for a single project. According to the Banker Survey, only two of the nine banks responding to this question 22 percent, offer this combined service.

Legal, Regulatory and Municipal Issues

Hungary has made progress in moving toward a legal process in which real estate is transferred freely and mortgages are established between parties. Banks believe that more work is required by legislators to enable holders of mortgages to enforce rights fairly and without undue delay. Some of the more important legal and regulatory issues raised by the Banks and their counsel are summarized below:

- Notary Requirement—The law allows a mortgage to be executed using a notary at a cost of 2 percent of the mortgage amount. A mortgage under notary seal permits summary foreclosure action in the event of default. If a notary is not used and the borrower defaults, a long courts foreclosure process is required to gain control of the collateral. Requiring a notary for summary foreclosure action is considered an unfair and expensive regulation, *but may be the most effective way of ensuring timely foreclosure in the event of default.*

- Recordation—In order to verify the developer's title to the collateral offered for a loan, the Bank must independently review the records in the Office of Land Registry. Under the law, a transfer of title or a mortgage is not considered final until formally recorded by an authorized official. In Budapest, there is a large backlog of transactions where formal recordation is pending and, in the meantime, handwritten notes of pending transactions are noted in the margins of the registry book. Such notations are not enforceable under the law. The status of the Land Registry is tolerable for land parcels and real estate that have not been transferred or mortgaged within the past 4 to 5 years, but it is a problem for transactions taking place subsequent to that time. According to a journalist who wrote a recent article on this subject, it will take 2 to 3 years, HUF 1 billion and more staff to clear the backlog in Budapest. Until then, the Banks must rely on imperfect title information for mortgaged collateral.

- VAT Reform—Developers and others involved in the development process often complain of the current VAT requirement as unfair and counterproductive to development. The common complaint is that VAT adds significantly to the cost of sub-contractors, services and materials. An important factor is that professional developers need to compete with self-help, which overwhelmingly use gray market labor, at a much lower cost. Some temporary relief targeted at helping developers compete with the informal construction industry might be advisable.

- Cooperation from Municipal Authorities—banking customers that rely on real estate development for their income (developers, contractors, construction firms, suppliers, etc.) claim that more municipal cooperation would allow more development projects to go forward. The Banks would also welcome more municipal involvement in terms of risk sharing on a project, timely municipal approvals for building permits, cooperation with road construction and utility work, input for problem solving, etc. Some of the Banks have stated that certain municipalities will not allow condominium or mortgage documents to filed on a project if the land is owned by the municipality until the project is completely sold. Such a practice adds to the developer's burden of pledging excess collateral for project loans.

- Enforcement of Legal Rights—As a relatively new law, the foreclosure law has received inconsistent interpretations among the courts. Since development projects involving housing units relate to special rights under the law for occupants, some uncertainty exists as to legal limits available to Banks in the event of foreclosure against a developer. In Section I of this paper it was stated that 67 percent of the banks responding in the Banker Survey wanted to expand developer lending. The other 33 percent that are not planning to expand sited unclear regulations on recovery rights as the main reason.

- Sharing Credit Information—The current credit information system is not effective, as it does not capture enough credit history and information, particularly for the medium size firms. The Banks would like to circulate a list of borrowers that are in default on existing loans, which would upgrade the current level of information. However, legal liabilities are a question for some Banks.

Solving the Issues

The financing issues raised by developers and bankers are formidable but not insurmountable. Our research with developers, bankers, lawyers and other experts in the business have led to formulating possible solutions, some of which are already underway. The table below presents the major issues and possible solutions:

Issue	Solution
BANKS	
Management/Organization	
More knowledgeable and experienced banking management/staff	Banks generally know that new organization structures and skills are needed. As Banks become more committed to this market, their strong interest in loan quality will force improvements.
Specialized Lending Departments	Likely to occur as development lending margins and loan portfolios increase. Already in place at some Banks. The presence of European banks in the market as co-owners or competitors will cause changes as Banks reorganize and adjust to meet loan demand by using management/organizational methods used in market economies are probable outcomes.
Technical	
Staff training needed: appraisal methods, municipal process, engineering/architect concepts, etc.	Developers or related Trade Associations could organize and present training courses to bankers. Appraisers, engineers and architects would be included. This would build lending confidence among bankers and establish lines of communications between bankers, developers and other professionals. Technical training is a natural progression of the management and organization changes noted above. Loan quality will dictate a strong training program for Banks in this market.
Lending Policies	
Non-Participants (Will Not Lend)	Unlikely that most banks will continue such a policy if strong market trends continue, yields improve for project loans relative to alternative investments and some of the Banks' basic issues are resolved.
Reckless	The historical perspective, new regulations and market forces will either discourage such a policy or the Bank will not survive.
Unreasonably Conservative	Such a policy appears designed to protect Banks against perceived uncertainties and defective underwriting. More progressive risk analysis and loan structure should reduce uncertainties and, therefore, unrealistic requirements imposed on the developers.
Profitability	
Market Potential	Bankers are not the only group interested in projections for the housing sector. Developers, contractors, construction companies, trade associations and local officials would all benefit. Projecting market potential will require reliable information and skill and a coordinated effort should produce the desired results. Once a model is developed and tested, updating projections with new data and making adjustments can be assigned to one group and circulated periodically. Should market potential prove strong, more financing is likely to flow to the participants.

Issue	Solution
Loan Quality	Banks should meet among themselves and share market information and risk management techniques that are effective in this market. This approach has been successful in other countries. Banks should draft new loan policies and standards, which are flexible (to meet customer needs) yet, firm. Policies and standards should be reviewed regularly and adjusted if necessary. Banks should reach out to foreign shareholder banks, corespondent banks and consultants for assistance with developing risk management techniques that will support loan quality. Banks and trade associations must continue to work together to develop more information channels. The current credit information project should be promoted vigorously and legal obstacles removed. Maintaining loan quality is difficult unless underwriters possess substantial information about the parties involved with a project loan.
Selective Practices Loan and Equity Requirements Trust Factor	Bank requirements should be carefully reviewed to verify direct relationships between requirements and the policies concerned. Starting out, the smaller developers should consider pooling their cash resources and forming joint ventures on a project in order to meet lending requirements. Developers must find a way of reducing the cost of housing developments. By reducing total costs, the developer lowers his equity requirement, enhances margins and usually reduces certain risk factors. Developers and Banks should continue meeting together as a group and communicating more as group and stress common goals. Only through communication and open discussions can trust barriers be overcome. More creative ways are needed for developers to utilize advance payments without weakening the Bank's position, jeopardizing completion of the project or risking a loss of advance payments (see Exhibit "A").
Financing Issues Liquidity and Mortgage Conflict	Once the industry determines the amount of financing required for developers and homebuyers, government policies should support the banking sector's liquidity and funding needs. The merger of larger banks may allow for more access to the capital markets. Financial institutions should continue to access foreign shareholders and correspondent banks for liquidity shortfalls. The Mortgage Bank should continue to sell its mortgage-backed bonds in the capital market and other liquidity measures must be tested. Legal and industry experts should form a group to study conflicting mortgage situations and recommend solutions.

Issue	Solution
Legal	
Notary	The Loan Recovery Working Group5 completed a study which included a comparison of Hungary's notary system and fee structure with that of other European countries. The findings from this study may assist advocates seeking to lower notary fees. It is possible that lower fees would lead to an overall increase in notary volume, fewer court foreclosures for non-notarized transactions and substantial cost savings to the courts. It is also possible that lower fees would result in a higher volume of notarized documents and higher overall fee income to the notary group. The study should be reviewed for guidance and alternatives going forward.
Recordation	Confidence in the system must be restored if Banks are expected to rely on title information. A consulting firm should be commissioned to recommend the staff, software, systems and other changes necessary to improve the current system significantly.
VAT	The government is studying this issue and is expected to include a VAT exemption for housing in the 1999 budget. As discussed above, a more targeted exemption might be more effective in addressing the specific problem of helping firms compete with the gray market.
Construction Finance Subsidy	A change that would reduce the magnitude of the subsidy but increase access by smaller developers would be a positive move that would contribute to the vigor of the sector.
Municipal Cooperation	This is another area where open communication among the parties can only benefit the developers, the Banks and municipalities interested in housing development. Allowing mortgages on municipal land, sharing the risks of construction and the transfer of title and collateral rights for construction projects involving the municipality are all complex issues that can only be resolved by hard work and cooperation. Hungary's housing strategy and development regulations was fashioned after European models. A group of bankers, developers and municipality officials should visit a European country that is well experienced with the issues facing housing developers. The training materials could be shared with professional colleagues in Hungary.
Enforcement of Rights	The following recommendation are taken from the Loan Recovery Working Group: —A notary should be used, particularly for development loans over a certain minimum amount determined by the Bank. —Bankers should clarify the ranking of collateral rights for a project before funds are disbursed and, in the event of default, carefully consider execution strategies and procedures. As the law evolves and legal cases are decided, more guidance will be provided by the courts. —Banks must periodically review legal documents to assure compliance with the law after amendments are passed and court cases are concluded. —Bank counsel should continue to meet as a group with Ministry of Justice, the Supreme Court, the Association of Banks and the Hungarian Lawyers' Society and seek

[5] USAID has helped to form and support the work of a cross sectoral working group – comprising representatives from the Ministry of Finance, banks, the courts, the executioners, notaries, and lawyers – to review current laws, regulations, and bank practices affecting the effective recovery of delinquent housing loans, and to propose recommendations to improve the process. The Working Group is expected to issue its findings in November 1998.

Issue	Solution
	clarification of their rights to collateral. —The Banks must communicate proposed changes to the laws that are realistic and still protect their enforcement rights. A group effort may yield better results.

CONCLUSIONS

While construction finance at present has a very limited role in Hungary, it seems to hold promise for the future of housing construction. Many of the problematic technical and legal issues have practical solutions, some of which we have tried to outline above. All market players – lenders, developers, home buyers, local governments, and the central government – will have the opportunity to take steps that can improve the process and make the residential construction industry more efficient and more affordable. As a result of this improvement - which should result in the decrease of the collateral requirement for loans for developers - construction period loans will be more and more accessible for smaller developers. The construction period loan subsidy can play a very important role in this development, if it is not withdrawn as suggested by the budget forecasts.

The Hungarian market is still uncertain, but there seem to be many growth areas on the horizon. The self-help segment offers some potential, as does the still pent-up demand for new larger housing. In particular, multi-family housing construction has come to a virtual standstill in the absence of professional development, and may yield rewards to developers able to tackle the organizational and financial complexities that typify that sector.

The most important step is to bolster trust between the developer and the bank or banks giving loans for both the construction and the purchase of the home. Mutual confidence between them and the homebuyer, and the local government when it is also a player would also be highly beneficial. But the developer-banker relationship is at the center of the development process, and both sides need to recognize the tremendous common interests they share. In addition, both these professions need to gain confidence in their skills to determine risk and potential profitability, so that they can embark on a greater diversity of projects in this challenging and rewarding field.

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APPENDICES

AND

EXHIBIT A

APPENDIX

Housing Subsidies in the Proposed 1999 Budget (HUF million)

	1995	1996	1997 Estimated	1997 Expected	1998 Estimated	1998 Expected	1999 Proposed	2000 Proposed	2001 Proposed	2002 Proposed
Housing Construction allowance	34,838	31,104	16,000	29,162	20,000	25,000	22,000	22,000	22,000	22,000
Advanced allowance	1,472	905	1,500	298	1,200	1,000	1,000	1,000	800	500
Subsidy for disabled people	2,589	2,514	2,000	2,372	2,000	2,000	2,000	2,000	2,000	2,000
Cost of disbursement	540	437	300	661	500	500	400	400	300	300
Retiring of guarantee			1,100	312	1,500	1,000	500	700	700	500
Social subsidy	28	63	100	327	600	600	5,300	10,000	12,000	15,000
Energy savings subsidy			200		300	100	300	300	300	300
Addition of fixed interest rates	8,000	6,290	4,160	4,986	2,200	3,500	2,200	1,500	600	200
Consumer credit for owners of housing savings accounts	646	581	600	522	300	300	300	200	200	100
Housing Savings subsidies					5,800	4,000	8,200	11,000	15,000	18,000
Interest rate subsidy	195	309	300	436	500	500	600	1,000	1,300	1,500
Construction period loans	500	1,356	480	2,011	1,500	2,000	2,000	1,000	1,000	1,000
Repayment subsidy	14,853	12,124	8,500	11,536	9,500	10,000	7,500	5,500	5,000	4,500
Housing loans from local governments	2,843	2,982	1,000	823	500	500	300	100	100	100
Cash flow	1,848	223	200	-238	200	200	200	200	200	200
Total housing subsidies	68,352	58,888	36,440	53,208	46,600	51,200	52,800	56,900	61,500	66,200

Source: Proposal for the National Budget for Hungary, 1999 (Ministry of Finance)

EXHIBIT "A"

Advance Payments: Preserving its importance to the developer while protecting the buyer, the bank and the project.

In Hungary, the developer/builder relies heavily on the collection of advance payments from buyers of housing units. These funds often mean the difference between bank financing (or no financing) and completion (or no completion) of a project. However, there are times when bank financing and advance payments are not enough to complete a project which may result in large and painful losses to the Bank and the buyer. How can the interests of all concerned be protected?

- The buyers must be protected, as they are the most vulnerable. Most of the time, their money is advanced before construction is begun or in the initial stages. Buyers are exposed to a total loss if 100 percent of the payments are used to pay project costs or repay the construction loan, before the housing unit is ready for delivery.

- The Banks look to the advance payments as some insurance (depending on the level of sales) that enough money will be generated to complete the project and repay the loan. Furthermore, large advance sales reduce market risk for the units. Eliminating the current use of advance payments altogether would discourage lenders at a time when more lending is needed.

- Developers generally lack capital to finance housing projects and advance payments are a necessary source of equity to qualify for loans and to pay project costs not covered by the loan. Again, significantly eliminating the current use of advance payments would severely limit the projects that could be developed by small to medium size developers.

One Proposal:

Let us assume construction of a housing project of 16 flats and advance payments are required:

	HUF
Total project cost	300 Million
Developer equity-to be disbursed before bank loan	100 Million
Loan approved by Bank	200 Million
Phase I	
Disbursement for development and begin construction	35 Million
Amount funded by bank	0
Advance payments received	0
Amount funded by developer	35 Million
Phase II	
Disbursement to continue Construction	65 Million
Amount funded by bank	0
Advance payments received	30 Million

A conservative approach with maximum protection for the buyer would require all 30 Million to be placed into a blocked account until the project is completed and the unit is delivered to the buyer. Such an approach would place enormous demands on the developer's cash and put the Bank in a position of not benefiting from the advance payment, as it would not be considered collateral.

Amount funded by developer (under conservative approach) 65 Million

A liberal approach with minimum protection for the buyer would require all 30 Million to be counted toward the developer's equity requirement. Such an approach would substantially lessen the cash requirements on the developer, allow the project to continue without bank funding during Phase II and expose the buyer to considerable risk which is, apparently, the present situation in Hungary.

Amount funded by developer (Under this approach)	30 Million (Advance Payments)
	35 Million (Developer's Cash)
Total Equity used to fund this disbursement	65Million

A combination of the conservative and liberal approaches would present a more acceptable alternative for the parties concerned. By allowing 50 percent of the advance payments to be applied to construction costs and 50 percent to be placed into a blocked escrow account, the buyer has protection over 50 percent of the advance payment and the developer has use of 15 Million HUF that will not have to come from his cash resources. Moreover, the Bank's interest is served as the project continues on schedule without a bank disbursement while sales continue during the next phase.

Amount funded by Developer (Under this approach)	15 Million (Advance Payments)
	50 Million (Developer's Cash)
Total Equity used to fund this disbursement	65Million

Phase III

Disbursement to continue construction	100 Million
Amount funded by bank	100 Million
Advance payments received	40 Million
Amount funded by developer	0

If the Developer is in compliance with the terms of the loan, it is conceivable that the entire 40 Million HUF in advance payments be placed in the blocked account (total is now 55 Million-Phase I and II) and the Bank fund 100 percent of the disbursement.

Future Phases

Since the developer equity requirement was satisfied in Phase I and II, the remainder of the project is funded by the Bank loan until the project is completed. Assuming a 20 percent profit margin, the following summarizes the accounts:

Total project sales expected	375 Million
Total advance sales (assume 75 percent during construction	281 Million
Total project cost	300 Million
Developer equity (100 percent disbursed)	
Buyer Payments	15 Million
Developer Cash	85 Million
Total Equity Requirement	100 Million

Loan approved by Bank (100 percent disbursed)	200 Million
Total in Blocked Escrow Account (281 Million - 15 Million for Phase I)	266 Million

Final Phase

95 percent of the buyers' advance payments are available and protected. When the developer delivers the units, these funds can be used to pay for the units and repay the bank loan and return some of the developer's investment. More funds are available to the developer as the remaining 25 percent of the units are sold. In the event of a problem with the developer or the project before the final phase, the buyers would have most of their payments protected and the banker would have the option of completing the project knowing that these funds are available to repay the bank loan during the final.