# WHAT'S HAPPENING IN HOUSING FINANCE IN HUNGARY

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The pace of change in housing finance in Hungary remains substantial. There have been significant recent events in nearly every facet. This year will be a good time for an event, such as the proposed conference, that will highlight the tremendous cumulative changes since 1989 and that are currently underway.

The format of this report follows the format of previous reports since 1994.

## TOPIC 1: EVOLUTION OF OFFICIAL HOUSING POLICY

In August 1995, the GOH set up a new housing policy advisory body, called the Housing Policy Council, and charged this body with formulating a new set of housing policy guidelines. In July 1996, the formulation and review process was completed and a new Housing Policy Concept was adopted.

The Housing Policy Council continues to coordinate the development of housing policy. In November 1996, the chairman of the Council, the Minster of Finance, created a committee of outside experts for the detailed review of housing subsidy policy. This Committee for Revising Housing Subsidies was authorized to collect data and perform analysis in all key areas of subsidy policy. It submitted an initial report in May 1997 and a final Report and Recommendations in February 1998. This report was supposed to be considered by the Housing Policy Council, but the government has signaled that, at least at this time, it is not seeking to make public changes in housing policy in advance of the elections in May 1998.

A detailed review and discussion of the Committee's Report is presented in Annex A. In summary, the Committee concluded that there is no numerical housing shortage, and that current subsidies that emphasize new construction need to be supplemented (and eventually supplanted) by matching grants to governments that are targeted for assisting housing of low income households through whichever approach is most efficient and effective.

The operations of the Committee are an excellent reflection of the improved policy making functions in the government of Hungary. Experts from the various interested parties and institutes were gathered and background studies were prepared in all four areas of focus of the Committee, (1) construction subsidies, (2) tax subsidies, (3) rental housing, and (4) rehabilitation. The Committee then debated these and formulated recommendations, including noting any significant views not held unanimously.

## TOPIC 2: USE OF THE DPM AND OTHER MORTGAGE LOANS

In 1996 and 1997, OTP made more (in volume) in DPM-type loans for new housing than in traditional subsidized annuity loans, because of the financial advantages of the DPM when borrowers are expecting to have additional children. By the end of 1997, more than 6,500 DPMs had been closed by OTP. There was also another 200 DPMs among the unsubsidized loans made for existing and rehabilitation (up from under 100 in 1996).

It appears that overall borrowing remains at very low levels. In addition, prepayments of loans made between 1989 and 1993 have continued at high rates. This is presumably related to the end of the first five years of deep subsidy (generally either 70 or 30 percent) on those loans made in 1989-91. By the end of 1997, the stock of outstanding housing loans is almost down to 1 percent of GDP, a level it will probably reach in 1998.

To some extent, this was a normal reaction to a high rate of interest. The OTP rate stayed at 32 percent until July, while the inflation rate and market interest rates fell throughout the year. And it is possible that most of the decline in new loans was accompanied by a decline in house purchases. Unfortunately, it is not possible to know exactly the level of house purchases, since there is no data series on this. However, from the information available, it appears that the public essentially has little preference for loans if they are going to be at all costly.[1] In that environment, it makes little sense to contract for a DPM which, while it allows you to borrow more, does so by spreading the repayments over a longer period and subjecting the borrower to the costly interest rate for longer.

The situation is not being helped by the continuing domination of OTP in the lending market and by the apparent judgement of OTP's management that housing lending is not a very profitable business. OTP has decided against any effort at marketing its loans or educating the consumer about the usefulness of borrowing for home purchase.

The most recent months have allowed us to see what a housing finance market could be like if there were sharp competition and consumer interest (and maybe more subsidies). There have been heavy marketing campaigns by the three competing Housing Savings Banks, with the end result of a large number of contracts and a good bit of awareness of the product (albeit, it is being mislabeled as a subsidized savings scheme, while it actually conveys no subsidy unless a loan is taken out).

## TOPIC 3: HOUSING FINANCE SUBSIDIES

By far, the largest on-going housing subsidy remains the Housing Construction Allowance (HCA). One of the most notable aspects of the large expansion of the HCA in 1994 is that it worked as lump-sum subsidies are supposed to. The beneficiaries could clearly see the benefits and reacted accordingly; the GOH

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[1] This begs the question of how the Hungarian housing market can operate on an all-cash basis, something inconceivable in the U.S. The key difference appears to be that the give-away privatization process, combined with the near wiping out of the pre-1989 mortgage debt and the negative population growth, has put most households into a position of owning or inheriting a home free-and-clear. Thus, as long as the only challenge to buying another house is to come up with the difference in value between the new and the old house, this can be accomplished by many without resort to a loan.

became aware of the full cost of the subsidy and also acted relatively swiftly. The result was that the subsidy was extremely popular but was significantly truncated in May 1995 due to its large revenue losses.

However, because of the way eligibility for the subsidy was defined, high levels of expenditures under the HCA were predicted by this observer to continue through 1996 and into 1997. Those predictions have been borne out, with 1996 HCA expenditures coming in at HUF 31 billion, close to the HUF 30 billion predicted in an earlier report and far more than the HUF 12 billion initially predicted by the Ministry of Finance (MOF).

Contrary to what this observer expected, and even more contrary to MOF predictions, the expenditures on the HCA remained very high in 1997, finishing the year at HUF 29 billion. This is further confirmation that, although the restrictions applicable to building permits after May 2, 1995 are tightening use in the Budapest area, rural areas, with their low cost structure, low past usage of the Social Policy Allowance (SPA) (because not many new homes were built recently), large families, and ingenuity circumventing rules (see below), may sustain usage into the future. Official forecasts are now for expenditures of HUF 22 billion per annum into the future.

The government now expects the HCA to remain as it is for the foreseeable future, with the intent that inflation will over time reduce its real value. Despite the decline in its real value, getting an HCA has become something of a "cottage industry" (literally) in some poorer, rural areas of Hungary. While specifics are hard to pin down, there are stories of families qualifying for a large HCA (HUF 2.1 million with 3 children) fronting for others in the home construction process, and other scams. Aside from fraud, there is the simple fact that this amount can substantially upgrade a poor quality rural house. The end result is that one of the poorest counties in Hungary, Szabolcs, received 25 percent of the HCA in 1996 with only 5 percent of the population. And the increase in the number of demolitions was almost as great as the increase in construction.

Hungary is now deeply embarked on another foray into a major housing subsidy scheme, the Housing Savings Banks (HSBs). These institutions were modeled after the German and Austrian Bauspar system and have some attractions as a subsidy scheme and some major flaws. This observer and many others thought that the flaws exceeded the advantages, but various political and commercial interests succeeded in achieving enactment.

The Hungarian HSB system boils down to a state subsidy of the interest on savings (essentially the state subsidy allows people to get the market rate of interest on savings while the HSB pays only 3 percent) so the HSB can offer low rates on loans, i.e., the customer ultimately benefits in the form of a low rate (6 percent) loan. Its small advantage from the perspective of social policy over subsidizing loans directly is that it requires a certain amount of savings. However, buying a house in Hungary involves a large amount of savings anyway, so it is unlikely that this will mean more savings. Its big advantage over some other subsidies is that the (indirectly) subsidized loan can be used for any housing-related purpose, including rehabilitation.

In its final form, the HSB subsidy was intended to attract primarily those people actually interested in a loan for housing purposes, rather than the broader and much more expensive systems of savings subsidies adopted in the Slovak and Czech Republics and exists in Austria. This would both limit the absolute level of expense and target it more to housing.

However, it appears that, unintentionally, the rate of return to saving under the contract will be higher than that available on alternatives. This is because the subsidy amounts were set in legislation in 1996 and apply to savings for the length of the contract (at least 4 years). Meanwhile, the decline in inflation has made it likely that market rates will decline substantially over the next few years. Specifically, the average market rate the next 4 years may be only 12-15 percent, while the HSB effective rate for contracts started in 1997 was 17.5 percent after 4 years.

The net result is that almost 300,000 contracts were concluded at the 1997 subsidy rates.[2] The subsidy due on the first 12 payments (40 percent) will cost at least HUF 7 billion (not all of which is payable in 1998, since it is due 2 months after completion of the 12 months savings. period) or almost three times the initial forecast. Since the government did not cut the subsidy back in line with its official forecast of declining interest rates in 1998, the system could become recognized as a generally attractive vehicle for savings, costing HUF 15 billion or more by the year 2000.

As noted in the July 1997 report, government regulation restricts the ability of the HSBs to promise ratios of loans to savings that would be very hard to fund in the future, i.e., it is unlikely that enough new savers will come on to support the loans. This was done because the government was worried about being politically “blackmailed” by the HSBs into expanding subsidies in order attract more savers later and bail out the HSBs with respect to their promises. However, the extreme popularity of the HSBs in these early years may yet pose challenges to achieving a flow of new funds later capable of providing low cost loans to the early savers.[3] This pressure will be especially hard to fight since a simply truly “neutral” policy may appear punitive to the public. A neutral policy would have the nominal percentage subsidy falling over time as inflation declines and the difference between market rates and the 3 percent HSB rate narrows. The public may perceive that this process is what is causing the HSBs to not be able to make a loan to all of the early savers. This subsidy, and the institutions that it supports, will be here and causing problems for a long time in the future.

Despite the elevated HSB subsidy expenditures, the overall trend in housing subsidy expenditures remains downward. To a great extent, this is because of the steady decline in the payments under previously committed subsidies. In particular, the subsidies on the loans originated prior to 1989 should fall off sharply if interest rates come down, and the payment subsidies on loans originated between 1989 and 1993 should also continue declining in 1998, accelerated by the passing of many of these loans out of their period of

[2] This was reported to be a disappointment to the major German Bauspar that entered the Hungarian market, which apparently expected a repeat of the Czech experience of 1 million contracts. Fortunately, the more moderate subsidy structure in Hungary should restrain the response (and distortion).

[3] To understand this, simply imagine if every Hungarian opens an account in the first two years, and hardly anyone is left to open one later. Where will the funds come from to fund the process of the early savers taking out their savings plus a large loan after 4 years?

deepest subsidy and the prepayment of many of them because of this event. The total level of new subsidies being provided, though, may not decline in real terms, because of the rise in burden of the HSB subsidies. Moreover, the government has indicated that, as the burden of old subsidies declines, it intends to add new subsidies to the sector. It is in this context that the report of the Committee on Subsidy Reform can be valuable in deterring the adoption of additional inefficient and untargeted subsidies.

**TOPIC 4: MANAGING CREDIT RISKS**

Credit risk continues to pose a potential major impediment to the housing finance market. In fact, OTP has now identified this as its major concern (this observer noted the severity of the problem in 1995). Only now are some signs appearing that management might start taking a proactive approach to the problem.[4]

The first set of loans to be eligible for reimbursement under the government's guarantee of the pre-1989 loans have completed all legal procedures. Those debts which could not be extinguished in the process are subject to payment by the MOF, upon submission of documentation as to the legal status of the default. In 1997, the MOF received claims for about HUF 300 million. In principle, the files on these claims could offer an opportunity to see in specific cases how the system of forced sale works and what circumstances are associated with default. It appears, though, that so far, the loans are of a type that OTP simply would not be making today, e.g., replacing houses lost to flood, loans on houses in small villages (with no potential forced sale market).

However, the effort by OTP to cash in on the MOF guarantee of the old loans has created some controversy. For a while, it seemed that the focus of the criticism was the foreclosure procedures themselves. Changes made in these procedures could undo a lot of the careful work to create an environment supportive of loan recovery. At this point, it appears that the focus has shifted to providing assistance to those households "unfairly" burdened by the changes in the terms of the pre-1989 loans. The whole area is fraught with danger, however, because there are many more defaulted loans made after 1988 which will be coming through the foreclosure system in the future. Too much assistance and sympathy for the defaulters may undermine the will of others to repay and also create concern among current lenders about ultimate recovery. This is an issue that merits continuing monitoring and intervention when possible.

The other important effort, however, remains that of getting the various parties with a stake in the foreclosure issue to agree as to what are the remaining problems and seek remedies. Fortunately, the Ministry of Finance has indicated that the government will not take on more of this sort of credit risk, directly or indirectly (they already are bearing 80 percent of the risk on loans eligible for subsidy, which are few

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[4] The steps they need to take have been laid out here before. They need to track default rates by cohort and utilize sophisticated analyses to identify what are the major sources of the problem (unemployment, inability to foreclose and evict, lack of effective auction procedures, location in small villages, etc.) that might both help in dealing with delinquency and help avoid problems in the future. OTP also needs to press for court rulings or other actions which could substantively improve their position.

though), so the pressure should be on the banks to solve the problems. With the assistance of the USAID program, the various interested parties have formed three working groups to (1) better document experience with loan recovery, (2) finalize the process for relying on notarized documentation, and (3) clarify the remaining barriers to execution of loan foreclosure and execution.

## TOPIC 5: SOUNDER LENDING PRACTICES

The banking sector has generally moved toward a more business-like mode of operation, a movement accelerated by the privatization to strategic foreign investors of all of the major banks except OTP. It is to be expected that new entrants into the housing lending market will apply modern professional methods to this area. Some efforts are also being made to collect minimal credit history information and to lobby for changes in the laws restricting such compilations.

While it is desirable for lenders to improve their underwriting and servicing of housing loans, this increased sophistication should also be applied to liberalizing some aspects of underwriting. In particular, if improved access to foreclosure and eviction reduces credit risks, they should reduce the requirements for guarantors, expand the allowable ratio of loan repayment to income and possibly accept less formal evidence of gray market income. It is notable that some of the popularity of the HSB contracts seems to derive from the fact that there is little underwriting or restriction on a loan after completing the savings portion.

## TOPIC 6: CREDIT ENHANCEMENT STRUCTURE

Despite the Government’s stated intention to consider creating a "loan guarantee institution," it appears that there are no plans currently to proceed in this direction. A contribution to the debate over such a guarantee institution was prepared in the author's January 1997 report, which concluded that the disadvantages of such a guarantee institution are greater than the advantages. It was recommended that an alternative strategy be pursued to create a "guarantee" institution which would charge each bank for any losses the bank imposes on it. This would retain the advantage of reducing the negative publicity that a bank might endure from a foreclosure while eliminating the moral hazard of a true general guarantee. However, the general topic seems to be frozen at the moment.

## TOPIC 7: ACCESSING LONG-TERM FUNDS

A general mortgage banking law was passed in April 1997. As was planned, a government-sponsored institution, the Land and Mortgage Bank (FHB in Hungarian), has been set up to engage in refinancing loans secured by agricultural land, with operations likely to start in June 1998. However, this institution has already indicated that it may go into mortgage banking for housing loans, as well loans for commercial real estate and municipal infrastructure.

It also appears that OTP and one or two German entities are considering the mortgage bank approach to fund raising. However, it is this observer’s expectation that they will not find it possible to compete with the commercial banks without special subsidies of the kind being provided in the Czech and Slovak Republics. These issues were discussed in separate reports entitled "Alternative Approaches to the Further Development of Housing Finance in Hungary" in July 1996 and "Is There a Role for Mortgage Banks in Hungary?" in April 1997. The main issue is how much spread the market will want on the bonds, over the rate on government bonds. The FHB is hoping that they can start with spreads of only 30-50 basis points, almost as low as for German mortgage banks.

The fact is that the capital market in Hungary is evolving rapidly. The public has access to investment funds that can manage large portfolios of bonds and stocks. The investment portfolios of insurance companies and private pension plans are also growing rapidly. It does appear likely that longer-term bonds, even possibly at fixed rates, will be accepted on the market. One of the next steps will be the start-up of a rating agency. It will be very interesting to see how well the market accepts one of the first issuances to be rated, the mortgage bank bonds. This has important implications for the issue of the future development of the housing finance market and should be watched carefully.

**TOPIC 8: ENCOURAGE COMPETITION WITH OTP**

The process of bank privatization and revitalization accelerated in 1996-7. This appears to have had the beneficial effect of bringing to Hungary bankers who perceive banking as necessarily encompassing an aggressive retail posture, including an active housing lending program. This "can-do" attitude towards retail banking stands in sharp contrast to the hesitant moves taken previously by the large banks with a base in commercial lending (for the good reason that they did not have the capital base and expertise to move aggressively into this area).

However, the most significant competitive element so far has been the appearance of the HSB system. Partly because of the foreign involvement in two of the three HSBs and partly because they are selling similar products in a mass market, they have been very aggressive (for Hungary) in their marketing campaigns and very oriented towards bettering their product and service relative to their competitors. (It is remarkable how more consumer oriented the OTP-LTP is relative to the main OTP.) This is one of the first times that the retail customers of financial institutions have been courted so assiduously, and it sets a good precedent and also opens the door to shifting much of the housing lending away from OTP.

The unresolved issue is whether the success of the HSBs will undermine the potential market for regular housing loans. To some extent, the answer must be not entirely, since the total available to a couple completing a four-year contract will be about HUF 2.6 million. This will not be worth a whole lot in 4 years from now, unless inflation comes down more rapidly than expected. A modest flat will probably cost 70 percent more than it does today, or perhaps HUF 6-10 million by then.

It is difficult to say what the bulk of the account holders have in mind. Currently, there are relatively few loans made for home purchase, but there appear to be a total of about 80,000 home sales of all kinds a year. One interpretation of these numbers is that most people who expect to participate in a home purchase in the next five or so years have opened an account. This could stunt the development of the housing finance system by pushing it into a special circuit that would be separated from the main financial markets. An alternative view might be that the thousands of households which formerly borrowed for renovations from OTP before the end of subsidies in 1994 are planning to take advantage of the subsidized HSB loans.

# ANNEX A

## SUMMARIZING THE REPORT OF THE COMMITTEE ON REVISING HOUSING SUBSIDIES

In November 1996, the National Housing Policy Council (NHPC) established an expert committee with the task to analyze the effectiveness of the housing subsidy system in Hungary and to recommend changes for the improvement of the system. The Council charged Mr. József Hegedüs, a member of the NHPC, to chair the committee and four subcommittees were created. During 1997, a variety of researches were undertaken, some with the assistance of USAID funding. In November 1997, Peter Mihalyi, Deputy Secretary of State, asked that the NHPC discuss the recommendations of the Committee at the beginning of 1998. For that purpose, the Committee submitted a report in February, 1998, with specific recommendations to be taken into consideration for the housing policy underlying the 1999 budget.

The recommendations were prepared by the working groups, and adopted unanimously, with reservations or other views explicitly noted.

The expert committee is urging the adoption of a new subsidy scheme which is rooted in a block grant approach. Local governments would be eligible for matching grants, on a one to one basis, for lump-sum subsidies paid for certain activities. The activities would have to be in certain categories and be targeted by income and wealth. In general, the committee believes that local governments are in a better position to discern the true economic circumstances of local residents.

Before arriving at this recommendation, the committee had reviewed the recent data on housing, particularly that contained in the Microcensus of 1996. It found that the housing conditions in general have continued to improve, with respect to average space per person and quality measures. The focus of concern was the continuing decline in the quality of the municipal-owned housing stock, partly because of continuing shortfalls in funding for maintenance (because of low rents) and because only the worst part of the public stock remains in the hands of local councils.

They also noted that, not only is the Hungarian population declining, but since 1990, even the number of households, usually buoyed by more single person households, also declined. There are now 200,000 empty houses, primarily in villages and towns in depressed areas, which affects the value of any other houses in those areas. (OTP now refuses to make loans in such areas of depressed house values.)

They also note that about 75 percent of the public housing stock has been privatized, leaving a very small (about 4 percent) social housing sector. Of course, these units are occupied disproportionately with families with many children, single parent households, single pensioners, households with unemployed head of the household, and poorly educated people.

The committee notes, and takes exception with, the emphasis of existing central government subsidy policy on assisting new construction. They take the view that households meriting subsidy should be able to choose how best to meet their housing needs.

On the other hand, the committee repeats earlier commitments to spending 4 percent of the budget on housing. This is the official policy of the government, but is excessive by international standards (and by the standard of relative housing difficulties in Hungary) and is not being observed currently.[5] The committee also make a general statement that this assistance ought to be well targeted, with at least half going to the bottom income quintile. Although no method of achieving this is proposed, it is recommended that better data be collected on who and what the subsidies are spent on.

The Housing Construction Allowance is sharply criticized as being inefficiently targeted. Although the committee accepts the continuation of the Allowance, it recommends a new system be set up, through the local governments, focused on assisting low income households with the purchase or improvement of existing flats. In addition, the funds could be used for renovating the common areas of condominiums or reconfiguring their heating systems.

It is proposed that HUF 6-10 billion be allocated for this subsidy, with an allocation by formula to each municipality. (A figure of HUF 8 billion is mentioned for renovation, but it is not clear whether this is all additional).

An additional program is recommended to help local governments strengthen their social housing sectors. The matching grant in this case is only for 30 percent of investment. Notably, it encourages local governments to purchase existing units as well as construct new ones. A total of HUF 3 billion is proposed during a pilot stage for this approach.

The committee makes three other notable policy remarks. It is concerned about the large amount of subsidies going to the contract savings accounts and requests that the nominal amount of the allowed subsidy not be raised in the near future. It also recommends that the repayment subsidy allowed for loans for renovations of common areas be continued. Finally, some suggestions are made with respect to more appropriate tax treatment of rental housing.

It is a fair question as to how the proposed block grant program will actually change the subsidy activities of local governments. After all, the local governments are already free to spend what they want on housing subsidies and they receive a total of over HUF 9 billion per year that is called the social normative for housing assistance (but which is unconstrained as to what it is spent on). In addition, the Housing Law of 1993 requires that they spend on housing in some form the amount that they receive annually from payments for privatization of council-owned flats.

It would be much easier to answer this question if more was known about local government activities in this area. What little is known is that, in the aggregate, they currently spent less than the social normative amount on housing and even their income from privatization (which is supposed to be spent on housing).

[5] Technically, if the housing portion of the budget includes the cost of the subsidies on the loans made before 1989, housing subsidies are still about 4 percent of the budget. But new commitments to subsidies are much lower, even including the Housing Savings bank subsidies.

The only data available currently is that, in 1997, they were planning to spend HUF 3.6 billion on utility subsidies and another HUF 2.4 billion on various subsidies to people buying homes.

Presumably, these expenditures by local governments are based essentially on their judgement as to how best to allocate their local funds. Thus, simply adding to the housing normative should generate little additional assistance. This suggests that the central government will have to change the calculations that the local government makes in allocating its resources. Since it is against the constitution for the central government to tell the local government what to do, the only option is to create an incentive for increased assistance. The simplest way of doing so is to offer to match local assistance. In principle, when a community has the opportunity to increase its total funding if it increases its housing expenditures, it will expand in that direction. But the expansion will not necessarily be so large, because some communities will take the opportunity to decrease their own resources in the area and replace it with the central government matching funds.

One alternative approach is to match only those expenditures which are in excess of the average of the previous three years' subsidies to the sector. The downside of this approach is that it requires local governments to actually pull funds from another sector. Apparently, there is some experience with a matching approach in another sector and it was found that the local governments were responsive and expanded their total expenditures in the desired directions. In any case, if this program is adopted as proposed, it will further increase the need for more extensive reporting to Budapest on housing subsidy activities.