Hungary Macro View

Fixing the Mortgage Problem

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- The Hungarian government has published a program that aims to alleviate vulnerabilities related to the large size of foreign currency debt.
- The government's plan to fix the exchange rate used for repayments of FX loans at a below-market level will have very limited impact on private consumption (probably less than 0.1% point), in our view. Although it may lead to a somewhat smaller number of defaults in the near term, we expect it to create a risk of more defaults in 2015 or later, when the grace period expires. In our view, this means that the government is simply exchanging the present vulnerability of households for future vulnerability.
- The available details suggest to us that the government's proposal shouldn't have a significant impact on the FX market.
- The most important result of the package will be the removal of moratoriums on evictions and foreclosures. Moratoriums contributed to moral hazard issues on the side of borrowers and stagnation in the real estate market.
- The legacy of moratoriums is a large stock of unsold properties that will complicate the recovery of the real estate market. In an attempt to alleviate this problem the government decided to limit the pace at which banks will be allowed to sell properties to the market after lifting the moratorium. However, in our view the limit is relatively low and thus may prolong the mortgage market adjustment excessively.
- In our view, the impact of the new FX mortgage market relief package on the economic growth will be limited as neither private consumption nor investment are likely to react significantly to the proposed changes. Having said this, we maintain our forecasts of approximately 3% economic growth in 2011 and slightly higher in 2012.

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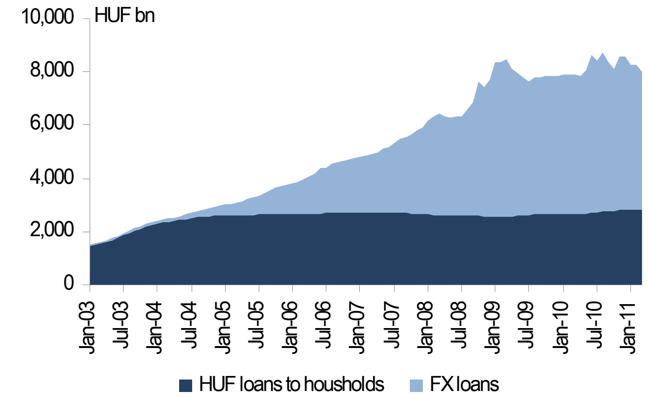
Fixing the mortgage problem

The Hungarian government has just finalized its works on measures aiming to revive the credit market. The key idea is that the new package will allow lifting of moratoriums on evictions and foreclosures but in exchange the government will implement measures that are supposed to protect borrowers and improve the functioning of the lending market. In this note we briefly summarize the announced solutions and try to assess their impact on the Hungarian economy.

Lower installments but little support for consumption

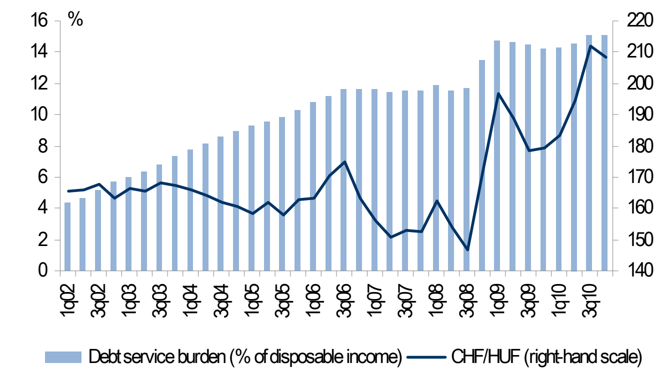
Of several government proposals, that which has attracted most attention is the law that fixes the exchange rate at which foreign currency loans will be repaid. This should not be surprising if one takes into account the size of the FX mortgage market in Hungary. According to central bank data, the outstanding foreign currency debt of households amounts to HUF 5.2 trillion, of which housing FX loans account for HUF 2.6 trillion (or 8.6% of GDP). Due to its size the FX debt has been a source of Hungary's vulnerability, as a depreciating forint has increased the monthly installments paid by households and contributed to a substantial rise in the share of non-performing loans. In order to reduce such risks in the future, the government is planning to fix the FX rate at CHF/HUF 180 (spot: 220) in the case of Swiss franc mortgages and at EUR/HUF 250 in the case of euro mortgage loans. Since monthly repayments will be done according to the reduced FX rate, households will benefit from lower installments – but only until end-2014 when the FX rate applied to mortgages will once again be allowed to move with the market rate. The whole scheme will be voluntary but available to all households with FX mortgage debt.

Figure 1. Foreign currency loans constitute almost 2/3 of household debt in Hungary



Source: NBH, Citi Investment Research and Analysis

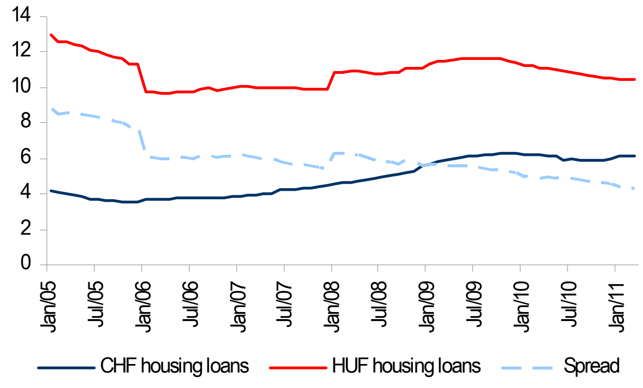
Figure 2. HUF depreciation in recent years has increased loan installments paid by households



Source: NBH, Citi Investment Research and Analysis

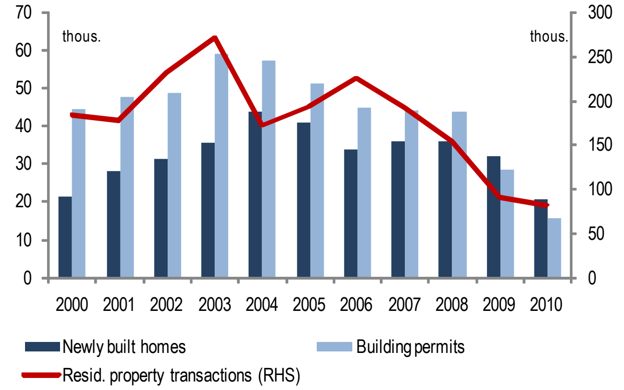
Lower installments will bring only temporary relief to households. This is because the shortfall in payments resulting from a difference between the spot and fixed rate will accumulate on a special account and will be booked as a new HUF loan (Collective Account Loan) that will need to be repaid after the end of a grace period (starting from January 2015). Since the interest rate on the new loan will be linked to the short-term money market rate, the whole change will imply only that a portion of the FX loan will be changed into a HUF loan. The idea behind this solution is to buy some time and avoid or at least postpone defaults by those borrowers who are hard-pushed to meet monthly payments at a spot rate but can meet them at a reduced rate. Obviously, the government is hoping that such a move will help boost private consumption while faster economic growth will lead to improvement in the labour market, which in turn would allow households to service future higher monthly installments.

Figure 3. Interest rate on HUF and CHF housing loans



Source: Citi Investment Research and Analysis

Figure 4. Falling number of building permits confirms that residential property investment came to a standstill



Source: CSO, NBH, Citi Investment Research and Analysis

Our rough calculations suggest the impact of the proposed measures on private consumption will be limited. Outstanding FX mortgage loans (for house purchases) are equivalent to approx. HUF 2.6 trillion, most of which is in Swiss francs. Given that average interest rate on CHF loans is 6.1% and interest on EUR loans is at 7.2%, we estimate that installments paid by households on their FX housing debt may be as high as HUF 260bn in 2011[1]. This in turn implies that fixing FX rates at the below-market level could reduce annual debt service payments of households by HUF 45bn.

The key question is how much of this amount will be saved and how much spent because this is precisely what will define the impact of proposed measures on economic growth. In our opinion, a safe assumption is that the propensity to consume will be low as highly leveraged households will look to reduce their debt burden relatively quickly. We assume that no more than 50% of any increase in disposable income will be spent, and this implies the proposed FX mortgage relief package may increase private consumption by no more than 0.1-0.2%[2] . However, assuming that only a portion of FX mortgages will be affected by the government's proposal, we think the actual impact on consumption will be even smaller (probably less than 0.1% point) and hence will have a negligible impact on economic growth.

Trading present for future vulnerability?

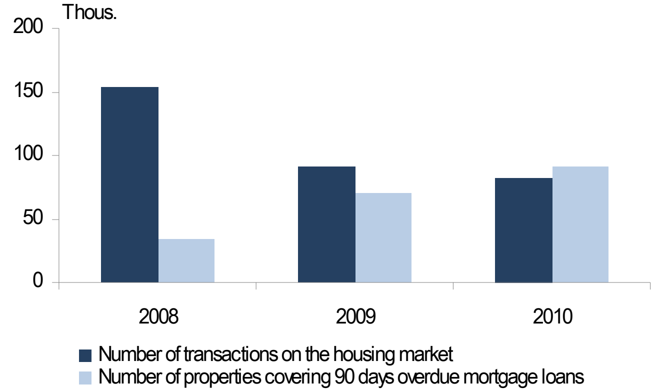
The government's plan reduces the present vulnerability of households at the cost of increased future vulnerability. After a grace period of more than three years, monthly payments will eventually rise as regular installments will be increased by the amount resulting from HUF loans accumulated on the special account. Additionally, if the forint fails to appreciate, monthly payments will be reset to a higher level resulting from the market rate. This implies that households may face a substantial increase in debt burden in the future. In other words, if households' income position doesn't improve sufficiently, the risk of potential defaults on FX loans will only be postponed.

[1] We assume that average time to maturity of outstanding loans is 15 years. In the case of 10 years to maturity, the actual debt burden would amount to HUF 345bn, while in the case of 20 years it would be HUF 225bn.

[2] The calculation has been prepared under an assumption that all households with FX housing debt will apply for lower installments.

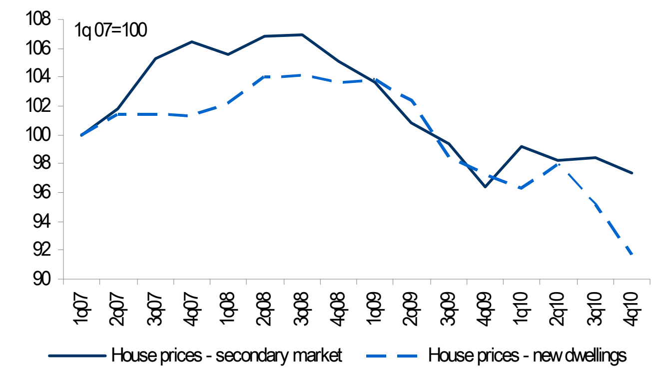
Since the government is to provide guarantees on loans it means the state will also accept additional foreign currency risk, thus making itself even more vulnerable to changes in CHF/HUF. That is because any depreciation of the forint would make defaults of households more likely and would raise fiscal costs. Taking this into account, we think the mortgage relief program doesn't actually reduce vulnerability but shifts it between periods and between particular sectors. However, we are not surprised by this, because we fail to see any solution that would succeed in eliminating the problem of high FX debt in Hungary. Obviously, the government's fiscal position and in particular a large public debt don't allow the state to take over risks from the private sector. In other words, there seems no easy way out from the problem of a high share of FX loans in banks' portfolios.

Figure 5. The number of houses the banks will be trying to sell is larger than the number of housing market transactions



Source: CSO, NBH, Citi Investment Research and Analysis

Figure 6. Hungary avoided a housing bubble but failed to avoid a downward house price adjustment



Source: CSO, Citi Investment Research and Analysis

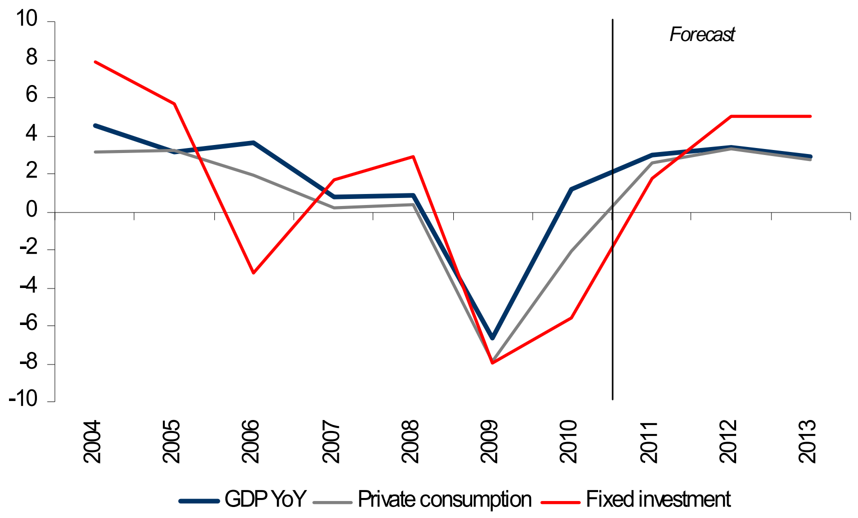
One of key concerns among market participants was that the mortgage aid program could lead to FX market distortions. However, the available details suggest to us that the government's proposal shouldn't have a significant impact on the foreign exchange market. Demand for CHF should remain the same as the combined amount of FX loan repayments and FX loans exchanged into forint (and accrued on special account) will not change. This implies also that the proposed FX mortgage relief package will have no immediate implications for the central bank's interest rate decisions.

It'll be a long time before the market starts functioning

Along with the FX debt relief package, the government also presented measures intended to revive the mortgage market. The housing market has been paralyzed by moratoriums on foreclosures and evictions that were put in place in order to prevent social problems related to defaults of households on loans. Due to their existence, banks were unable to sell collateral of mortgage loans which led to an increase in the number of unsold properties and a corresponding decline in the number of transactions. According to NBH estimates, the number of properties covering non-performing loans almost tripled, jumping to 90,700 in 2010 from only 33,600 in 2008 (Figure 5). In turn, the number of transactions fell to only 82,000. The freeze on the mortgage market seems to be one of several factors behind disappointing fixed investment performance and behind a decline in house prices (Figure 6). Indeed, although Hungary didn't experience a property boom in the run-up to the crisis, it suffered a 7.3% nominal price decrease in e case of secondary market houses and a 15.4% nominal price decrease in the case of new houses in the period 4Q 2008-4Q 2010. After adjusting for inflation, real house prices declined by as much as 15.7-23.1%.

Although the moratorium is to be lifted in July, the build-up of a large pool of unsold houses is a serious risk factor. That is because attempts to sell properties in a non-functioning property market could lead to a deep drop in prices and a resulting devaluation of collateral. This could negatively affect Hungarian banks as it could potentially lead to further write-offs. In order to avoid such a situation, the government wants to reduce the amount of properties sold by banks into the market. Therefore initially banks will only be allowed to sell large-value properties, and starting from 4Q 2011 there will be a system of quarterly quotas on the number of properties to be sold. In 4Q 2011 the quota will be set at 2% of the non-performing portfolio and it will rise to 3% in 2012, 4% in 2013 and 5% in 2014. The existence of a limit seems indeed necessary as the unregulated sale of properties held by banks on a very illiquid market would probably lead to an even deeper decline in house prices and thus a greater devaluation of properties constituting collateral for loans. However, it seems to us that an initial limit of 2% of the non-performing portfolio per quarter may itself be a source of market distortions. Indeed, such a low limit will prolong the adjustment process in the housing market and therefore it is likely to take a long time for the market to start functioning correctly.

Figure 7. Hungary is likely to see growth of approximately 3% in 2011-2012



Source: Eurostat, CIRA forecasts

The government's package includes also a plan to establish the National Asset Management Company. The NAMCo would be allowed to purchase properties at discounted prices and in exchange for this it would give debtors rental rights. However, we still don't know details of how any such operations would be financed. Additionally, the government is planning to lift a ban on EUR loans but this would be available under strict conditions (EUR loans would be made available to wealthy customers with income in euros).

Conclusions

- The most important consequence of the announced package is that it opens a door for removing moratoriums on foreclosures/evictions. Otherwise, without such a move the housing market would probably remain in stagnation while the banking sector would suffer losses with an increasing stock of depreciating collateral.

- However, it seems to us that the pace at which the housing market will likely return to life will be slow due to low limits on the number of properties banks are allowed to sell. This implies that residential investment may grow very slowly and act as a drag on economic growth in coming quarters.
- Fixing the FX rate on mortgages at a below-market level may bring temporary relief to indebted households but we estimate its impact on overall private consumption will be marginal. In our view, the above measure will not reduce Hungary's vulnerability related to its large stock of FX loans. Instead, it will simply postpone the risk of increased defaults until 2015, when households will need to start repaying accumulated debt resulting from below market FX rates.
- All in all, the approved FX mortgage package doesn't change our economic growth forecasts for Hungary. We continue to expect GDP growth to reach 3% or slightly more in 2011 and 2012 (Figure 7), but this will remain vulnerable to changes in the global growth outlook. Furthermore, since the approved mortgage package seems neutral for the FX market, we are not changing our interest rate forecasts either. We believe the NBH will leave rates on hold at 6% until year-end and we expect moderate interest rate hikes in 2012.

Appendix A-1

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