THE HOUSING FINANCE OUTLOOK FOR COMMERCIAL BANKS

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1. Introduction

By now the Hungarian commercial banks have overcome the problems they inherited from the socialist system and those accrued during the early years of the transition. In 1998 the sector is dominated by profitable banks with strong owners and adequate capital. The inherited segmentation of the market is gradually easing and the banks offer a broadening range of services. However, there is still one segment in which only a very limited group of banks operate. It is the housing finance sector.

What could therefore be the reason that OTP, which made housing loans in the past as an obligation assigned by the State, still dominates the housing market segment of the market while the majority of commercial banks have already entered the other segments of the housing market (deposit collection, account management, consumer loans and loans backed with securities)? Can this phenomenon be explained with the features of the banking sector, or should we look at other sectors of the economy for the reasons? Without having a general idea about this, it is impossible to answer the question of what can be expected in the future, whether housing finance is going to increase in the activities of commercial banks or the other participants of the financial sector will undertake this role.

These questions cannot be answered comprehensively in this presentation. By giving an outline of the major events of the recent past and present situation of the banking sector, and the attractions and threats involved in housing loans at the moment, the intention of this presentation is to give only a few aspects for the discussion of the issue.

2. Transformation of the Banking System

2.1. Inheritance from the past: lack of capital and funds, segmented market

The development of the Hungarian commercial banking sector in the recent past and the current market activities have been influenced a great deal by the inheritance of the past. The commercial banks established during the banking reform of the 80s were capitalised only at a low level compared to the risks involved in their portfolios. The very strong connections between the new banks (MHB, OKHB, BB) – recently separated from the central bank (NBH) – and particular sectors of the national economy determined their business policy and increased the risks of their loan portfolios for a long time. Elimination of this sectoral dependence was made even more difficult for the bank as the Government did not allow companies to choose their bank freely during the very first years following the reform.

The successor banks of the NBH did not have sufficient funds for their business activities and therefore they remained heavily dependent on refinancing from the central bank during the first years after the split. Although in 1989 commercial banks were allowed into the retail and foreign exchange business, the strong segmentation of the market of funds eased only very slowly and has not quite disappeared even by today. (*Várhegyi, 1995.)*

The capital position of the banking system was also deteriorated by state regulations and the weaknesses in supervisory activities. During the previous years the regulations did not force the banks to generate provisions. The preference for fiscal interests as opposed to prudential considerations – producing tax on "profit" rather than keeping reserves – drained a considerable amount of fictitious income from the banks. The methods and instruments required for the enforcement of prudent banking activities developed only very slowly in the banking regulations. It was only in 1991 that a Banking Act was adopted which gave real "teeth" to the Banking Supervision. Even that Act contained numerous brakes due to the weak positions of the majority of the regulated banks.

The capital and funding problems, the inherited customers and the high risks involved in the loan portfolio indicated a sharp drop of the initial, at least on paper, high banking profitability, which turned into serious losses as a considerable number of corporate customers collapsed.

2.2. Transition period: bank crisis and consolidation

The important members of the Hungarian banking system became technically insolvent by the end of 1992. The severe and extensive crisis of the banking system was primarily the result of the collapse of the east European – including the Hungarian – economies, fast devaluation of the national assets involving the collateral items of loans and the latent crises which had been present for a long time before and came to the surface. Although in the corporate sector the increasing signs mass insolvency existed from the end of the 80s, the majority of the banks reacted to these signs with a delay. The delay was due to the anomalies in ownership, strong dependence on the Government, inherited bad features and professional weaknesses (*Várhegyi,* 1995).

Since the crises could not be managed only within the competence of the individual bank, the State also had to be involved in recovering the activities of the banking system. As a result of the debt consolidation[1] aiming to clean up the 1992 financial accounts, the equity of the banks increased significantly and their capital adequacy ratio also improved. However, the majority of the banks recreated their bad debt portfolio within a short period which was partly the result of stricter classification regulations and partly the deterioration of the economy. Therefore the bank consolidation scheme which was launched in 1993 tried to solve the problem of the banks' bad portfolios through capitalisation based on the assumption that the basic problem was caused by the fact that the banks adjusted capital figure was too low compared to their lending risks. This is why the Government gave a capital injection to the affected banks in two steps (*Balassa,* 1996.)

During the debt, debtor and bank consolidation schemes between 1993 and 1996 the Government used government bonds in the value of approximately USD 3 billion (10% of the GDP then) to assist the banking sector. Although the banks could not be consolidated because of the extent and importance of the crisis, the process involved serious professional and political mistakes (*Botos,* 1996, *Várhegyi,* 1996). There is no doubt though that the consolidation process led to significant improvement in the position of the banks by improving the balance sheets of the banks in equity and portfolio quality as well as their profitability positions.

2.3. Privatisation of banks

The process of bank privatisation began in Hungary as early as at the end of the 1980s when minority share packages of some banks were sold to

[1] Within the debt consolidation scheme the government exchanged the bad debts of banks for 20-year government bonds with market interest rates.

foreign investors. In addition, the ratio of foreign participations in banks founded as joint venture banks was also increased. However, the begun privatisation process was interrupted by the consolidation required as a result of the bank crises.

Following lengthy discussions, the Government adopted a concept at the end of 1993 according to which the privatisation of banks should take place primarily with the involvement of strategic investors. Apart from OTP, this was the concept on which the privatisation of consolidated banks was based between 1994 and 1997. Bidders were selected primarily on the basis of the proposed purchase price and promised capital increase. Strategic investors in general acquired a majority share and were given an option for future purchase and they made significant capital increases. Attempts to sell a few small banks in a very bad shape failed. Such banks were quietly removed from the market or they were integrated into the Hungarian Development Bank which remained a State-owned institution.

There were two exceptions to the Hungarian bank privatisation process which led to strategic and concentrated investments. These two exceptions were the two largest retail banks, OTP and Postabank. In the privatisation of OTP Bank, which is a savings institution, still in 1995 the government decided to exclude strategic investors intending to create a diversified capital structure dominated by institutional and financial investors. As a result of these efforts, with a 10% share held by the social security self governments, the bank was sold to foreign institutional investors, Hungarian institutional and private investors, the employees and the management in the framework of private placement. In the case of Postabank a similar capital structure was developed through less deliberate government policy in which the withdrawal of strategic investors, which had bought a stake in the bank before, had a very important role.

By the end of 1997 the privatisation of the Hungarian banking system was practically completed. Only banks specialised in very specific functions (Eximbank, Hungarian Development Bank, Land and Mortgage Credit Rt.) remained State-owned. The future of Postabank, which has lost its equity and required assistance from the Government and therefore has a State-held majority, and that of some other small banks with little capital is still an open issue.

The privatisation of the Hungarian banking system has led to a special capital structure which differs from the structure even in the majority of the developed countries (*Várhegyi*, 1998a). In the total capital of banks the State-held stake fell to one fifth and, parallel with that, the ratio of foreign shareholders, primarily strategic investors, exceeds 60%. The pragmatism suppressing the "national" ideology was an excellent opportunity for the Hungarian government to involve also strategic investors who were willing to strengthen the capital position of the Hungarian banks to find a long lasting remedy for the bank crises. This allowed not only for the fast conclusion of the bank privatisation process, but also facilitated the stabilisation of the banking system. The positive impact of Hungarian bank privatisation with the involvement of foreign strategic investors on the speed and transparency of the process was striking compared to the experiences of bank privatisation which took place in the other transition economies.[2]

2.4. Entry of new participants

It was also the pragmatism of the Hungarian governments and its pushing into the background of ideological considerations that made it possible for foreign banks to enter the Hungarian market and acquire considerable segments. The fact that foreign banks could establish a more weighty position at the Hungarian banking market than in the other transition countries was also due to the easing of the segmentation of the market as well as the fast demolition of the barriers of the activities. In contrast with the other transition economies in Eastern Europe, where the licensing practice of the country restricted foreign participations, banks which entered the market could establish their retail business and finance the Hungarian companies.

The new banks entering the market and established mostly by foreign banks and financial institutions gradually reduced the initial high concentration of the market and contributed to the erosion of monopolistic positions. Although because of the initial ban on free choice of banks, the flow of customers between banks began only in the 90s, the escalation of the bank crises only accelerated this process. The loss of market by the large banks, which inherited a bad loan portfolio and a risky customer base, took part

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2 See *Ambrus-Lakatos and Schaffer*, ed. (1996), *Ábel and Székely* (1997), *Bonin J.P.* (1995), *Bonin, Mizsei, Székely, and Wachtel* (1998), *Borish, Ding, Noel* (1996), *Pénzügykutató Rt.* (1998), *Wachtel* (1996).

simultaneously with the fast expansion of foreign and joint venture banks which had more favourable positions.

In 1989 the banks were authorised to provide retail banking services while the former retail banks were given a universal commercial banking licence. Foreign exchange transactions were also gradually liberalised. The regulations and fast liberalisation of the licensing practice gave an opportunity for banks with adequate capital and the right professional support to operate with the widest choice of services and most extensive customer base.

The new market participants with a “clean card”, i.e. with no inheritance or restrictions, established marked positions in the most profitable customer and business segments at the beginning. Beside financing large corporate clients which does not require costly development (e.g. branch network) they could also select their retail clients. Therefore, despite the easing of the segmentation of the market, the Hungarian banking sector was still polarised heavily in profitability: the profitability of the financial institutions with foreign shareholders was considerable higher than that of the State-owned banks. In addition to the undeveloped banking technology, the profitability of retail banks was also deteriorated by costly mass banking products, yet the income of corporate financing large banks was drained by provisions generated for the high proportion of bad debts.

This profitability polarisation began to reduce only after the completion of privatisation, in 1996 and 1997 (*Várhegyi*, 1998b). However, the process of banks, which have difficulties in getting rid of the inherited lose cost management and bad branch utilisation will definitely take a few years.

3. Current Position of the Commercial Bank

3.1. Size of the banking sector and market structure

The weight of the Hungarian banking system in the economy is still less than that in the developed countries: the grand total of balance sheet totals of the bank is only 70% of GDP[3]. The relatively low ratio is also due to the fact that

[3] In the EU countries this ratio corresponds to Greece while in other countries it varies between 80-300 (*Szelényi,* 1998.)

as a result of the strict regulations for the compulsory reserves, the proportion of off balance sheet activities is relatively high.

The little importance of the Hungarian banking system in the economy is reflected both in deposits and loans: bank loans represent 26% of the GDP, and deposits amount to 38% of the GDP figure. The low ratio of loans is due to the weak creditworthiness of the majority of the Hungarian companies although in 1997 dynamic increase began in the banks' lending activities. The lending activities are also reduced by the aspect that the volume of retail loans is very low in the balance sheet total of all banks, representing only 4%. The low ratio of deposits is related to the low income of the population and the people's intention to save. In addition, the draining effect of the insurance sector (insurance companies and pension funds) as well as investment funds also represent an important factor.

In 1998 altogether 37 commercial banks, one development bank, one export-import bank, 3 contract savings institutions, 242 savings co-operatives and 8 credit associations operate in Hungary with a total network of approximately two and a half thousand units. There are 24 branches for 100,000 citizens, which is not very low on its own, but many of them have only a small turnover, bad technical facilities and a few products.

To date the level of concentration has been declining in the banking market which was due to the erosion of the inherited markets and the expansion of the banks with foreign shareholders entering the Hungarian market. In 1997 the five largest banks held 54% of the market, while the largest ten had an aggregate market share of 72%. Apart from the market leader OTP competition has been concentrated a little: 5 banks have a larger market share than 5%, 7 banks have a 2-5% market share and 5 banks possess a 1-2% share at the market. The weight of OTP, which enjoyed a quasi monopolistic position at the retail market for a long time, is also declining continuously although at the moment it still controls 25% of the entire market, 60% of the retail market and 90% of the local government market.

The differences in the weight of business and customers of commercial banks are caused more and more by the strategies while the role of initial positions is gradually declining. As a result of increasing banking and non-banking competition the majority of banks aim at universal banking activities. The considerable-sized banks possess 3-4 financial institutions (broker firms, leasing firms, investment fund management companies, pension funds).

Beside the commercial banks and savings banks and credit associations new participants also appeared at the Hungarian, although their market share can only be measured in thousandth. Owing to the laws adopted in 1996 the contract savings institutions also appeared at the Hungarian market; in 1997 three institutions began to operate and two of them were founded by one, and one was founded jointly by three commercial banks. IN the joint foundation of the State and a few commercial banks, the Land Credit and Mortgage Bank was also created. In 1998 the German HypoVereinsbank also established its mortgage bank in Hungary. A few credit institutions specialised in consumer lending (Opel, Porsche, Ford, Cetelem) also increased the number of banks operating at the retail market.

The Hungarian banking system is still dominated by commercial banks: their market share reaches 90%. There is only one institution which operates as a development bank. It is MFB, and it has a 2% market share. To date only one mortgage credit institution began to work. The eight small specialised financial institutions possess 2-3% of the market, while the 242 savings co-operatives and eight credit associations have a 5% market share.

3.2. Financial position of the commercial banks

Despite the serious capital losses, the total capital of the commercial banks has increased. This was due to foundation of banks by foreigners (increasing the total aggregate registered capital of the banking sector) and the capital injection provided to the privatised banks by the owners (approximately HUF 45 billion). As a result of all that, between 1994 and 1997 the registered capital of the banking sector increased by 13%. It is even more important that the shareholders' equity, determining the activities of the banks, increased by 35% in real terms which was mainly the result of the profits left in the banks by the owners and the increasing capital and profit reserves.

The stability of the commercial banking system, which has strengthened its capital position, is reflected by the relatively high capital adequacy ratio and the spectacular improvement of the banking portfolios, While the rules of debt classification were made stricter, the ratio of classified assets and, within those, bad and doubtful debts, fell to a very little proportion.

Following the lowest point in bank crises, until 1996 the profitability of the sector was gradually improving and, at least with regard to the ROA, it exceeded the average of the banking systems of the developed countries (*Szelenyi,* 1998). The improvement of profitability and the relatively high average profitability figure originated from commercial banks owned by foreign banks. The top list of the banks based on average profitability between 1994 and 1997 contains only banks which have been controlled by foreign strategic investors for a long time (*Varhegyi,* 1998).

The decline in profitability in 1997 was mainly reflected in stronger competition, which was also reflected in the shrinking of average interest margin. However, the general decline in profitability also involved an increase in specific expenditure, which was caused by the modernisation and network development investments in some banks.

The efficiency indices of the Hungarian banking sector is in harmony with the international experiences related to developing/transition as well as developed bank markets (*Claessens,* 1998). At the turn of the 80s and 90s the foreign banks entering the Hungarian banking market could in the beginning use the market advantages involved in the less developed market. However, as a result of consolidation and privatisation, some competition conditions developed at the Hungarian market too which eliminated these options. These days it is no longer enough to be present at the market with a few more developed products among a limited range of customers (e.g. multi-national companies, affluent private individuals), as it was sufficient a few years ago, but the activities must be extended to all market and customer segments so that the advantages of the economies of scale could also be used.

Table 1. Changes in the Financial Position of the Banking Sector between 1993 and 1997

Description	1993	1994	1995	1996	1997
Size					
Number of banks	42	44	43	42	42
Balance sheet total (HUF billion)	2 631	3 072	3 693	4 458	5 678
Balance sheet total as a % of GDP	74	70	66	65	appr.66
Capital positions:					
Registered capital (HUF billion)	257	296	220	216	303
Shareholders' equity (percentage)	148	209	296	379	530
Capital adequacy ratio (HUF billion)	11.5	15.6	18.3	17.6	18.0
Efficiency:					
Profit after taxes (HUF billion)	-154.0	12.3	42.0	61.4	53.1
Profit after taxes as a percentage of assets	-5.8	0.5	1.1	1.4	0.9
Profit after taxes as a percentage of shareholders' equity	-1.0	5.9	14.2	16.2	10.0
Operating expenses as a percentage of total assets	2.9	3.1	3.2	3.3	3.4
Interest margin, average **	4.3	4.3	4.7	4.0	3.5
Portfolio quality: Bad and doubtful debts as a percentage of loans	20.0	12.1	7.8	4.1	2.0

* without savings co-operatives

** interest income on interest bearing assets – interest expense on interest bearing liabilities

Source: Annual Report of the Hungarian Money and Capital Market and the National Bank of Hungary

3.3. Structure of liabilities and placements

The ratio of more than one year external liabilities dropped significantly, from 22% to 13% while own liabilities stabilised around 10%. This decline was partly due to long-term refinancing from the central bank and the decline of long-term retail funds. Among the more than one year external liabilities foreign loans represent a significant and increasing ratio. In the placements the over one year placements reduced from 50 to 40% and, within those, more than one year loans to retail customers fell from 8% to 3%. (Table 2.)

Table 2. Asset and Liability Structure of the Banks as a Percent of the Balance Sheet Total

Description	1993	1994	1995	1996	1997
Structure of liabilities:					
Own liabilities and subordinated debt	9.6	8.6	10.1	10.4	12.0
More than one year external liabilities:	21.1	22.5	19.3	15.1	13.2
of which: from the population	5.3	4.8	3.1	2.7	2.2
from the central bank	8.8	11.5	8.2	5.1	3.1
from abroad	3.2	3.8	5.6	5.0	5.5
Total more than one year liabilities	30.7	31.1	29.4	25.5	25.2
Structure of placements:					
More than one year placements	48.9	53.8	46.8	40.4	40.8
of which: to population	8.3	8.2	6.3	4.1	2.8
to businesses	10.2	11.8	10.5	10.7	13.3
to the budget and central bank	24.0	27.7	24.3	21.4	18.4

* together with the subordinated debt

Source: Annual Report of the Hungarian Money and Capital Market and the National Bank of Hungary

4. Role of the Commercial Banks in Housing Finance

4.1. The structure of the retail banking market

The retail banking market is still dominated by two commercial banks (OTP and Postabank) as well as savings co-operatives. Even despite the falling tendencies of the last few years, the market share of OTP still exceeds 50% in retail funds, while savings co-operatives have an approximately 11% share and Postabank's share is around 10%. The remaining approximately 30% is shared among K&H, ABN Amro, Budapest Bank, Mezőbank and the Hungarian Foreign Trade Bank. All the other banks together have 10% of the retail funds.

The prospective retail connections of the banks are best indicated by the number of accounts managed since, in addition to the collection of funds, this creates an opportunity for the extension of lending services, including housing loans. With regard to retail account management, the market share of OTP is still 80% (1.9 million accounts), and Postabank in the second place is not even anywhere near it with its figures (300,000 HUF and 100,000-150,000 foreign exchange accounts). In the market of retail account management K&H, ABN Amro and BB have a considerable share.

Despite the decrease in concentration, the share of OTP and savings co-operatives reached 73% in the *retail loan* market even in 1997. The next 18 percent was shared by six banks with a 1.5-6.3% market share each.

The *market of housing loans* representing half of the retail loans is even more concentrated: 95% of these loans were extended by OTP and the savings co-operatives in 1997 too. To date only very few banks have launched their housing finance activities. K&H has been engaged in this business since 1996 but it provides loans only for home purchases and refurbishment. Although their interest rates are lower than the OTP rates, their total loan portfolio has not reached HUF 1 billion yet. Postabank has extended loans for home construction and purchases since 1997. However, its loan portfolio is not significant yet, although the conditions of the loan are competitive. (Table 3.) OTP and Postabank extend loans to customers with a contract with a contract savings institution at an interest rate which is 1 percentage point below the ordinary interest rate of the bank.[4]

The real interest rate of housing loans is very high compared to actual consumer and construction industry inflation (12-13%), reaching 12-13%, while the forecast inflation is dropping. The interest rates on housing loans are 8-9 percentage points higher than the marginal costs of funds of the banks and the highest inter-bank interests.

[4] Since the deposits are part of the collateral for such loans, in fact they fall in the category of loans backed with securities See *Mérő* (1998)

Table 3. Conditions of Housing Loans in October 1998

	OTP	Postabank	K&H
Loan objective	purchase, construction, refurbishment	purchase, construction, refurbishment	purchase, refurbishment
Interest on market rate loans	variable, 27% if there is a deposit with OTP contract savings institution, 25% in the case of DPM, 25%	variable, 26% if there is a contract with a contract savings institution, 25%	variable, 25%
Management fee	annual 3% (2% in DPM)	annual 1% for purchase annual 1.5% for construction (+1% loan assessment fee + 1% commitment fee)	monthly 0.1% for the entire loan
Loan ceiling	-	-	max HUF 8 million
Income requirements	Payment/income ratio < 33%	Payment/income ratio < 33%	
Maturity	max 25 years	3-15 years	max. 8 years
Payment	equal or deferred		equal
Collateral	establishment of a lien	establishment of a lien, perhaps further collateral	establishment of a lien

Even after the offer[5] for advance payment encouraged with debt forgiveness, the portfolio of retail loans and, within those, housing loans has been declining continuously in real terms (and in 1995-1996 in nominal terms too), so that the volume of new placements has not reached the amount of payments (*Table 4).* Nor were new entrants able to reverse this trend.

[5] In 1991 the State agreed to pay HUF 82 billion of the debt of borrowers who agreed to pay their debt in advance and who paid HUF 59 billion themselves. As a result of this scheme, the portfolio of housing loans dropped to two thirds.

Table 4. Retail Funds and More than One Year Retail Loans of Credit Institutions (portfolio, HUF billion)

	1996		1997		
	portfolio HUF b	breakdown %	portfolio HUF b	change %	breakdown %
Total retail funds	1860	100.0	2145	1.5	100.0
of which: long-term	234	12.6	249	6.4	11.6
Total retail loans	225	100.0	219	-2.5	100.0
of which: long-term	202	89.8	185	-8.4	84.5
Of long-term loans:					
housing loans	146	64.9	114	-21.7	52.1
• old preferential	41	18.2	32	-20.3	15.1
• other	105	46.7	82	-22.2	37.4
Loans for goods purchases	12	5.3	10	-13.2	4.6
Other* long-term loans	44	19.6	60	36.4	27.4
Housing loans as a % of loan portfolio	6.1		5.3		

Source: Annual Report of the Hungarian Money and Capital Market Supervision

* primarily loans for purchasing motor cars and other consumer and personal loans

The weight of mortgage loans is also declining in the total loan portfolio of the banks: while between 1992 and 1994 they represented 10%, by 1997 they dropped to 5.3%.[6]

The volume of housing loans is very low even measured as a percentage of the annual available income of the population, as it does not even reach 5%.[7]

4.2. Retail banking in the strategy of the banks

Due to the high penetration of the corporate market, more and more commercial banks have begun to look at the retail service in recent years.

[6] It must be noted that this was an outstandingly high ratio in the East European countries, which was the result of a unique subsidy system applied in the region See *Ábel and Székely* (1997)

[7] During the first half of the 90s this ratio was 77% in the UK, 69% in the USA, 51% in Japan, 48% in France, 15% in Italy. The peak value in Hungary was 15% at the beginning of 1991 when the old preferential housing loan instrument still existed. See *Zsoldos* (1997)

The appearance of competitors with developed banking technology resulting from their foreign professional background forced the traditional retail banks, primarily the quasi monopolistic OTP, to develop their services. As a result of increasing competition in the retail market, very rapid development occurred during the last two years in the account and card services, as well as consumer loans.

The appreciation of the retail market is reflected in the efforts to expand the branch network and the ambitious future plans which will enable the banks to extend their customer base. The banks plan to open altogether approximately 150-200 new branches in areas which are poorly supplied and in the largest business and shopping centres (*Jakus, 1998).* The majority of banks are working on the extension of their telephone services, installation of ATMs and establishment of computer links. Consumer loans, universal services and the integration of non-banking institutions falling into the shadow of commercial banks, are becoming a more and more important area in acquiring the retail market.

The estimated growth of the Hungarian economy also supports the increasing importance of the retail business in the strategy of commercial banks. The rapid growth of the economy, the increase in the income of households, and the development of banking services give good grounds for the extension of the market. At the same time, it may be a factor reducing the activities of the banks that the structure of financial savings is changing: the ratio of household savings placed directly with the banks is falling while the ratio of savings flowing into the insurance sector (primarily pension funds) and investment funds, encouraged also with tax credit, is increasing. The household savings which are placed directly with the banking sector meet transaction needs and represent short-term liquid reserves.

The activity of commercial banks at the retail market is also encouraged by the EU accession in the near future. The full liberalisation of branch foundation, the extension of services across the borders together with full liberalisation in capital transactions as well as the future principle of the "single passport" might result in the appearance of new competitors in the Hungarian banking market. The commercial banks need to consider more and more those competitors who do not come from the financial sector. They should prepare themselves more and more for competitors from the increasingly unified European market. As the single European market becomes stronger, and risks are mitigated, as well as the Hungarian market is liberalised, the investment funds may begin to increase very rapidly, crowding out banks from the market of retail funds.

The banks are trying to prepare for the increasing competition represented by banking and non-banking sectors primarily with the extension and modernisation of their product range, and the development of conditions of universal services.

4.3 Attraction and aversion of housing finance

Experience shows that while, in order to expand their markets, commercial banks turn more and more towards the retail market, *housing finance has not yet become a target for their market strategy.* Though the idea of launching housing finance surfaces among the intentions of some banks from time to time, commercial banks typically bide their time.[8]

Why is it that housing finance plays such a scant role in the business strategies of commercial banks?

Yet the *attraction* of housing finance could be great in the increasing competition, with the more and more narrowing corporate loan market. Banks compete fiercely for lending to large and medium-size companies with good credit rating, which is amplified by the expansion of capital market channels other than bank loans (stock and bonds market). Prime rates nowadays barely exceed the banks' marginal costs of funds, which is reflected by diminishing bank interest rate margins. Lending to the multitudinous small enterprise sector which involved high risks and/or high banking costs does not pose an attractive alternative to banks.

On the other hand, retail clients offer an expanding market segment to banks in the long run. Recognition of this fact is reflected in the more colours on the palette of retail bank products and the growth of bank branch networks. This palette could accommodate mortgage loans and, within that, housing loans.

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[8] According to press news, Takarékbank, in which the German DG banking group has an interest, intends to establish a mortgage bank (*Világgazdaság*, p. 17, 7 October, 1998). ABN Amro, which is expanding its retail market, also gave some thought to housing finance, but finally - referring to the small size of the market - gave up the idea.

There are a number of reasons which could explain why housing finance does not present an attractive business to banks in Hungary. The following may be highlighted as presumably *aversive* factors for banks:

1. Compared to the loan amount disbursed, mortgage loans have *high information and handling costs*. This is especially true for housing loans and even more for housing construction loans. Not only is it indispensable to have a broad branch network due to the demand for local presence, but also special staff is needed for housing lending. In addition to property appraisal, separate personnel is required for the ongoing monitoring of construction (which is a condition to staged disbursement). The disbursement of subsidised loans is encumbered by the fact that banks need to set up a special system in which state subsidies and loan installments repaid by the debtor "dovetail". The cost of this is returned only in case of a significant volume of loans.

2. *The mortgage lien as a collateral to the loan* still does not function properly in Hungary, in spite of the re-regulation of both lien and foreclosure by the court in recent years. To be able to apply its lien, the bank has to wait for the rather lengthy foreclosure procedure of the court which usually takes years (*Horváth*, 1998).

3. As the lien in practice does not represent an appropriate means of enforcing repayment of the principal and interest, in addition to the lien collateral, banks try to reduce their *lending risks* by stipulating additional conditions which increase the likelihood of repaying the loan. These include income certificates, the requirement of surety(ies), involvement of the spouse as co-debtor (*Magyar Hírlap*, 5 October, 1998). All this not only renders the evaluation of loan applications lengthy but very often puts off applicants. Besides the extensive practice of hiding income for tax evasion purposes, only an extremely small part of Hungarian population has income reported (e.g. in tax returns) which would be sufficient for repaying a more substantial loan amount. Reduction of lending risks is impaired because no debtor information system has emerged between banks active in the housing finance business.

4. Due to the above, both lending risks and costs related to lending are high which, incorporated in loan interests, give rise to extremely high (deflated by consumer prices, 12-13 per cent) *real interest rates*. The real interest

rate deflated by housing prices was especially high in recent years, it usually exceeded 20, and from time to time, 25 per cent (*Zsoldos*, 1997). High real interest rates are also counter-selective: they do not present an enticing alternative for those with high income and/or wealth whilst it allows those with lower income to take out only small loan amounts. This latter, however, is not attractive for banks, due to high unit costs.

5. Demand for housing loans was also curbed by *high inflation*. Nominal interest rates of over 30 per cent made effective repayment very fast (repayment instalments mean a greater real burden initially, which was limited by the population's ability to pay) (*Zsoldos,* 1997). The deferred interest payment scheme developed in order to eliminate this effect of inflation, however, increases risks for the banks, especially in a situation where the debtor's future income is hard to predict.

6. Due to high and uncertain inflation and the low degree of predictability of money market processes, it is difficult to treat *interest risks* in an appropriate manner acceptable to both the bank and the debtor. The maturity structure of bank funds, the absence of really long-term funds does not allow for lending with matching terms for assets and liabilities which would elminate interest rate risks (*Kohn,* 1998)[9]. Hungarian banks largely relay interest risks to debtors by variable interest loans. In the case of decreasing inflation and decreasing market interest rates, this method is advantageous for banks if the re-pricing of assets follows that of liabilities with a delay. On the other hand, it is exactly this that creates additional burdens and means a great degree of uncertainty to the debtor, especially if - as in Hungarian practice - the change is not tied to a clearly defined reference yield (*Horváth*, 1998).

7. Demand for housing loans is low in Hungary due to a number of reasons.[10] The narrow market which presents an uncertain future does not entice most banks to develop this business due to the high one-time

[9] It has to be noted that, though instruments which are suitable for bridging the matching of terms and handling market risks have developed and are widespread also in the Hungarian market, the Hungarian bank supervision monitors the co-ordination between banks' assets and liabilities to this day.

[10] Some more factors in addition to those already mentioned: elimination of the quantitative shortage of housing; the low proportion of loans for existing housing; the relatively low regular income of the population; the loss of value of housing assets compared to financial savings (*Zsoldos*, 1997 calculates that privately owned housing assets dropped to half between 1991 and 1996).

costs of setting up this business and the high constant costs of maintaining it. As we have seen, only a few of Hungarian commercial banks have retail accounts in the range of hundreds of thousands and a broad branch network. In the absence of sufficient demand, even banks that have entered this market in recent years are not able to make use of their capacities (Postabank, K&H).

As can be seen, a significant part of the factors listed reflects the constraints of the demand side. Insufficient loan demand, understandably, reduces the banks' willingness to set up the housing finance business. Low demand can be attributed partly, of course, to the still weak competition in housing finance and unfavourable conditions offered by banks. In the light of the competitive situation in the commercial banking market, however, it seems probable that the break in the trend and the boom in housing finance can be expected primarily from an increase in demand.

4.4 Will the role of commercial banks in housing finance increase in the future?

The increase in the role of commercial banks in housing finance is subject to a number of conditions. In this paper we cannot attempt to assess and forecast all factors (including among others the population's willingness to build and purchase homes, or the elimination of legal and administrative obstacles in enforcing rights under a lien). In the following, we will look at the question only from the perspective of the lending opportunities and willingness of banks.

The housing finance activities of commercial banks are subject to the structure and cost of their funds. The cheapest funds that could be eligible as resources for long-term loans are current account deposits, which, having a high degree of liquidity, warrant lower than market level interest rates. The steady or possibly increasing stock of these accounts allows for avoiding "posterior" re-financing of long-term loans as well as re-investment of funds with longer terms which may carry a significant market risk if there is uncertainty concerning inflation and real interest rates. As long as the money market is uncertain, inflation is relatively high – and thus it is not possible to extend long-term fixed interest loans –, interest risks may be mitigated by the flexible pricing of assets and liabilities. The decreasing inflation which is expected to further reduce enables safe pricing for banks as the re-pricing of loans (reduction of interest rates) may be preceded by that of deposits. The main uncertainty factor today is the change in money market *real interest rates*, which is due to both the changing foreign exchange market situation and the unpredictable nature of Hungary's economic policy.

Due to the expansion of savings opportunities offered by financial institutions[11] operating at regulation costs lower than that of commercial banks, a shift in household savings has been witnessed over recent years (*Table 5.*).

Table 5. Structure of household savings (%)

Savings types	1995	1996	1997	Sept. 1998
By form of savings:				
Cash	10.8	7.7	7.3	11.7
Deposits and securities of credit institutions	64.8	61.5	43.3	38.6
Total non-credit institution securities	18.5	22.4	40.1	37.3
Insurance and pension fund together	5.9	8.4	9.3	12.4
Total	100.0	100.0	100.0	100.0
By maturity				
Over one year savings	20.6	27.0	31.1	n.d.
of this: HUF deposits	2.5	3.5	3.1	n.d.
Under one year savings	79.4	73.0	68.9	n.d.
of this: HUF deposits	22.4	38.9	22.4	n.d.
foreign exchange deposits	33.3	7.8	6.7	n.d.
sight deposits	6.6	11.3	10.1	n.d.
Total	100.0	100.0	100.0	100.0

Source: NBH

The bulk (nearly 70%) of retail savings still have a term of under one year. Savers who are careful due to the high and unpredictable rate of inflation, low and not infrequently negative real interest rates and the increasing uncertainty of existence, in search of liquid investments have preferred short

[11] Regulation costs of commercial banks are augmented by the internationally high rate of compulsory central bank reserves in addition to obligations set out in the Act on Credit Institutions (strict operating requirements, general reserves, provisions, deposit insurance).

terms. This is reflected by the inverted shape of the yield curve over the past years and by the fact that long-term yields are lower than short-term ones.[12]

The enduring reduction of inflation, the expansion of real income, the strengthening of the authenticity of economic policy, however, is expected to change this behaviour. Under conditions like that, the term of fixed-interest savings instruments can be lengthened (this is already perceptible in the Treasury bond market), which could be accompanied by the mitigation of interest risks for long-term lending.

Due to the more widespread use of cash-saving retail banking products (transfers, cards) and the decrease of inflation, cash savings are expected to subdue which increases the deposit balance of current accounts. Even so, the proportion of bank deposits - and mainly deposits tied down for a longer period - in retail savings is expected to keep diminishing as an increasing portion of these go to pension funds and investment units.[13]

A part of expected money market processes (decreasing inflation, more predictable market interest rates, expansion of current account deposits, increase of personal income) are favourable for the banks' housing finance activities, while another part of these processes (the continuous flow of savings to competitor institutions in the capital market) may restrain these activities. The time when the banks' willingness to launch the housing finance business will actually perceivably increase *depends primarily on the change in demand*.

I have not addressed the future competition by housing savings banks and mortgage bank(s). It is difficult to assess today what the proportion and relationship will be between commercial banks and these special institutions in housing finance. The increased presence of housing savings banks which operate rather unlike a market entity is subject primarily to the government's policy. In the money market environment which is expected to stabilise, mortgage banks can play an important role in housing finance as well (despite the fact that the primary aim of establishing the first such bank was to finance agriculture on a lien basis). The share capital requirement which might be said very high in the Hungarian context (HUF 3 billion) indicates in

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[12] It has to be noted that the quick and continuous decrease of inflation over the past two years also plays a part in this.

[13] Following the fall in the stock exchange savings were withdrawn from investment funds, but this trend is not likely to endure.

any case that the majority of commercial banks will attempt direct mortgage lending as opposed to establishing mortgage banks in the housing finance market.

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