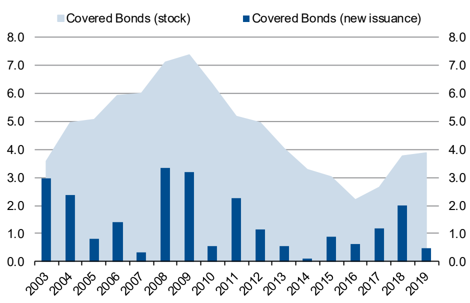
Hungarian covered bonds: better credit fundamentals support euro market comeback

Things could be about to change in the Hungarian covered bond market. Since the mandatory conversion of foreign-currency mortgages in 2014, the market has fallen from grace with international investors and been purely domestic. But fundamental credit support and the credit quality of Hungarian cover pools are on a par with international peers and could support the highest ratings. Once EU harmonisation has aligned the existing covered bond framework, we expect Hungarian issuers to re-enter the international stage, potentially with a green flavour.

Hungary was among the first CEE countries to create a covered bond framework, back in 1997. Based on the German blueprint, it ticks a lot of boxes and provides investors with a strong safety net. Yet covered bond issuance did not soar as it did in Western Europe.

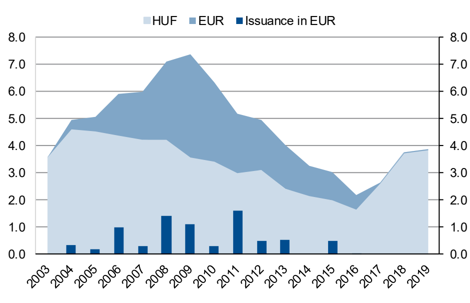
Part of the reason for that is even though Hungary has a high home ownership rate (86%), only 17% is financed with mortgages. Combined with the high deposit funding of Hungarian banks, there was not an urgent need for capital market funding and covered bonds failed to attract much demand.

Figure 1: Hungarian covered bonds



Source: Scope, ECBC

Figure 2: EUR-denominated CBs



Source: Scope, ECBC

Hungarian euro benchmark issuance short-lived

Hungarian covered bonds entered the international stage in the run-up to the 2007-08 Global Financial Crisis. However, the GFC wake-up call and the switch to risk-off meant that Hungarian euro issuance peaked in 2008 and issuance fully stopped in 2015.

Coupled with the fall of the sovereign's credit quality into non-investment grade category, investor appetite for the flavour of Hungarian covered bonds – jelzáloglevél – diminished as international investors significantly curtailed credit lines.

Where flight to quality in other European countries meant covered bond issuance soared after the crisis, the Hungarian market was curtailed by another domestic complexity: the high share of foreign currency mortgages and their forced conversion in 2014 (see box on the next page).

But investor concerns about the quality of Hungarian covered bonds were unfounded as only the first recourse – the banks – not the credit quality of cover pools suffered.

Since then, the Hungarian covered bond market has become fully domestic and Forint-denominated but even domestic appetite has waned along with international interest. From a height of EUR 7.7bn covered bonds outstanding in 2009 (see Figures 1 and 2), volumes reduced to less than a third to EUR 2.2bn in 2016. By the end of June 2020, volumes had picked up and stood at EUR 3.9bn.

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Strengthened mortgage market providing more robust cover pool assets

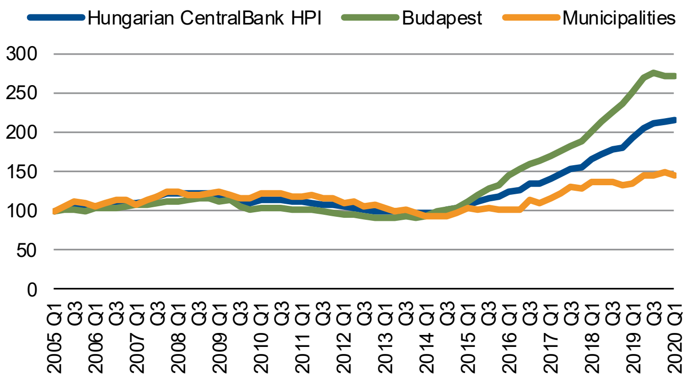
Credit quality of Hungarian banks and mortgage market improved

Today, most Hungarian banks have stronger balance sheets compared to when they were last seen in international covered bond markets.

FX mortgages are no longer a negative risk factor to the credit quality of Hungarian borrowers. Similarly, the structure of the Hungarian mortgage market and borrowers' resilience against shocks has improved.

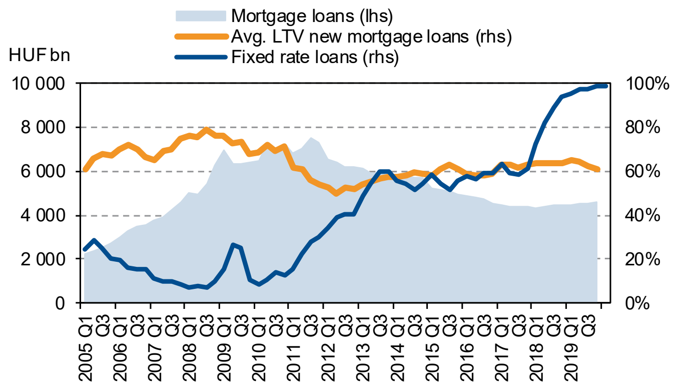
House prices in Hungary remained broadly stable between 2005 and 2015 (see figure 4). Prices during this period were not impacted by the strong increase in housing loans. Mortgage lending increased from HUF 2.2trn in 2005 to HUF 7.5 trn in Q3 2011 but subsequently stagnated and fell, decreasing to HUF 4.3trn in 2018.

Figure 3: Hungarian HPI Development



Source: MNB, Scope

Figure 4: Housing loan market characteristics



Source: MNB, Scope

Housing prices started to soar significantly from 2014. On the back of strong GDP growth, the average nationwide house price index more than doubled (to 214 in Q1 2020 from 97 in Q1 2014). While we observe strong diversity of the HPI development across the country, not surprisingly, in Budapest, prices appreciated strongest, to 275 in Q3 2019 from 94 in Q1 2014).

Strong appreciation of house prices prompted measures to curb growth.

House price growth likely to moderate

Similar to most other countries, reducing unemployment and the low interest-rate environment have increased affordability of housing in general. In Hungary, consumers also benefit from the Home Purchase Subsidy Scheme for Families (about EUR 1,700 or HUF 600 per child) and the reduction of VAT on new dwellings (to 5% from the standard rate of 27%) in 2016.

We do not expect the latter to remain a driving factor for further HPI growth, however, as it only applies to building approvals granted until 2018. According to the Hungarian National Bank (MNB) this means that 52% of completions in 2020 (60% in 2021 respectively) will already be subject to the standard 27% VAT rate and thus become more expensive. New developments might even come to an abrupt stop and thus moderate HPI growth further. In combination with Covid-19, the first impacts have already become visible in first quarter house prices, which either started to plateau (whole market) or even decreased (Budapest and for municipalities).

Correction of house prices will likely not turn in a slump.

Low average leverage of households.

A price-to-income ratio of about 17 for new houses and apartments in Budapest compares to an average of 12 for other European capitals and clearly points to an overheated housing market. However, we do not expect house prices to slump nor housing-related NPL ratios to increase significantly. Hungarian borrowers are less leveraged than most other European households and a relative stable LTV ratio of 60% (compared to a maximum LTV for new loans of 80% and 70% if used as collateral for covered bonds) means that speculative investments have on average not increased significantly.

High affordability and long fixings contribute to a robust housing market

Low interest rates continue to support affordability. Further, the structure of the mortgage market has significantly strengthened compared to when Hungarian banks were last in the international covered bond market.

In 2008-09 most mortgages were floating-rate and foreign currency-denominated. At the end of 2019, almost all mortgage loans were HUF-denominated and the share of fixed-rate loans is approaching 100% (see Figure 4). Fixed-for-life loans account for 25%, loans with five-year fixings account for 28% and loans with a 10year fixing, 45%.

Switch to a fixed-rate mortgage market with long fixing periods is credit positive

The strong increase in longer-term fixings reflects the 2018 changes to one of the MNBs macroprudential tools: the debt-to-income ratio[1]. When initially introduced in 2015[2] HUF lending was incentivised with a payment-to-income ratio (PTI) for domestic currency loans of as high as 50% compared to FX loans that only could be granted with PTIs of up to 30% (in EUR) or 15% (other currencies). Since October 2018, borrowers taking out floating-rate mortgages with fixings of less than five years need to demonstrate a debt-to-income ratio (DTI) of 25%. This compares to borrowers fixing for at least 10 years or for life, who are allowed to have a 50% DTI ratio.

The case of Hungarian FX Mortgages

Similar to other CEE countries as well as Austria, high domestic interest rates prompted Hungarian borrowers to take out or reference their loans to a foreign currency (often CHF and JPY). Following strong growth in the early 2000s, FX loans made up two-thirds of Hungarian banks' loans by the end of 2010; 90% denominated in CHF and most related to mortgages.

Borrowers often did not take into account the appreciation risk of foreign-currency loans, which meant that macroprudential risk strongly increased. In 2010 Hungarian regulators imposed a halt on new FX mortgage lending. Between September 2011 and February 2012, borrowers were able repay their loans at a government-set interest rate and banks were required to reimburse borrowers' fees. Last, banks were forced to convert back CHF loans to HUF in 2014.

The drastic and unilateral government measures resulted in a significant hit to the banks' profitability and capital. On the positive side, the conversion happened before the Swiss franc rose significantly on 'Black Friday' of January 2015. As such, severe problems for many borrowers – such as negative equity when appreciation ate up instalments – were avoided.

At the same time, capital market access for Hungarian banks became severely impaired by the forced conversion. Hungarian covered bond issuance dropped to a mere EUR 91m in 2014. Only in 2018 did it reach levels seen a decade before.

Domestic revival first – International next ?

MNB pivotal for the revival of Hungarian CBs

For both mortgage and covered bond markets, regulators have been pivotal to the positive changes, laying the groundwork for a successful covered bond revival. The most important from a covered bond perspective was the introduction of a macroprudential tool – the Mortgage Funding Adequacy Ratio (MFAR).

In line with the thinking behind the NSFR, the MNB stipulated that from the first quarter of 2017, 15% of HUF-denominated residential mortgages needed to be refinanced with longer-dated covered bonds[3]. As is typical for most CEE countries, Hungarian banks remain strongly deposit-funded and thus short-term funded. Since it was introduced, the

[1] https://www.mnb.hu/en/pressroom/press-releases/press-releases-2018/the-amendment-of-the-debt-cap-rules-has-been-published

[2] https://www.mnb.hu/en/pressroom/press-releases/press-releases-2014/upper-limit-on-the-payment-to-income-ratio-protects-households-as-a-debt-cap

[3] http://www.mnb.hu/en/financial-stability/macroprudential-policy/the-macroprudential-toolkit/instruments-addressing-liquidity-and-financing-risks

MFAR regulation has been amended twice[4] and today, at least 25% of mortgages granted by banks need to be refinanced via covered bonds.[5]

Strengthening the domestic market is credit positive

Mandatory MAFR requirement supports growth and is credit positive for covered bonds

We view the MFAR as credit positive for banks and covered bonds in particular. The regulatory-driven refinancing requirement speaks strongly to a high likelihood that a covered bond will not be placed in passive wind down but will remain a going-concern funding instrument. Covered bonds are highly likely to retain recourse to a supportive issuer – even if the latter is bailed in. The existence of the MFAR is therefore a supportive element in our rating, in particular the fundamental credit support analysis[6] for covered bonds.

Comparing the EUR 3.6bn[7] stock of residential mortgages in Hungary to outstanding covered bonds, the MNB already has achieved its MAFR goal. Almost 30% of residential mortgages are already financed with covered bonds.

As a result, Hungarian covered bond issuance has revived and come out of the trough (see figure 2). Outstanding covered bonds have increased and stood at about EUR 3.9bn in Q2 2020.

Laying the ground for ESG covered bonds – MNBs Green Programme

Fostering energy-efficient lending grooms the ground for green covered bonds

Following a consultation in January 2019[8], MNB introduced another “first” which can also be supportive to a re-entry of Hungarian covered bonds. To foster green financings MNB introduced a preferential risk-weighting for green mortgages[9].

To provide firmer evidence for the hypothesis that energy-efficient buildings will improve affordability for borrowers (thus lower their likelihood to default) and stabilise the value of housing collateral (thus reduce loss given default), MNB has started a four-year project running between 2020 and 2023 in which banks receive capital discounts for private, energy efficiency improving renovations.

Capital benefit is limited in total to 1% of a bank’s risk-weighted assets. Green financings receiving a 5%-7% risk-weight discount for eligible mortgage loans. In addition, banks also need to incentivise borrowers with an interest-rate discount of at least 30bp and provide additional data points to allow the MNB an in-depth review once the programme has closed.

High demand for housing and thus financings, combined with the MAFR as well as the green programme will allow the Hungarian covered bond market to further grow and attract new investors.

MNB’s CBPP makes the central bank the single largest investor

Hungarian CBPPs strengthens demand for covered bonds…

Covered bonds are a preferred asset class for central banks and their purchase programmes. It comes to no surprise that the MNB has also made use of covered bond purchase programmes. Under its first purchase programme – running between December 2017 and December 2018 – it accumulated about HUF 381.4bn (EUR 1.01bn) of covered bonds from primary and secondary markets. Covid-19 prompted the MNB to revive its CBPP and introduce a second programme in April 2020. At the end of July 2020, an additional HUF 150bn (EUR 428m) of covered bonds had been purchased.

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[4] Raised to 20% effective October 2018 and 25% effective October 2019
[5] A ‘de-minimis’ of HUF10bn exists which exempts smaller banks from the requirement,
[6] See Scope’s Covered bond rating methodology, section 3.2 Resolution regime and systemic relevance analysis .
[7] EMF Hypostat, page 117
[8] https://www.mnb.hu/letoltes/az-mnb-zold-prgramja-1.pdf
[9] https://www.mnb.hu/en/pressroom/press-releases/press-releases-2019/mnb-introduces-a-green-preferential-capital-requirement-programme

…but also makes MNB the single largest investor

Combined holdings of more than EUR 1.4bn mean the MNB has become the single largest investor in Hungarian covered bonds. Grabbing more than one third of outstanding domestic covered bonds, its share is not too far from the ECB's share in the iBoxx. As such, from the perspectives of issuers and the central bank, as well as regulators because of the MAFR requirement, covered bonds are likely to be seen as a systemically relevant refinancing tool worth preserving.

Harmonisation will improve the credit quality of jelzáloglevél

How does Scope determine the credit quality of Hungarian CBs?

The domestic importance of covered bonds in Hungary has grown significantly over the years. But how has their credit quality evolved?

The ability of covered bonds to be rated above the issuer as well as its sovereign is mostly driven by our view on their fundamental credit support. Scope's covered bond analysis first focuses on the strength of the legal framework and the ability of a covered bond to remain a going-concern funding instrument.

Only in a second step, in a gone-concern analysis, does the strength of the cover pool and its expected loss become relevant. The cover-pool analysis identifies how prevailing risks are mitigated and whether additional uplift – ultimately up to the highest ratings[10] – can be factored into the rating.

The legal framework for Hungarian covered bonds

In the first step, the legal framework analysis, we identify whether:

i) the covered bond structure can transit smoothly away from the insolvent issuer,

ii) the bond continues to pay principle and interest thereafter,

iii) how credit, market and liquidity risks are contained

iv) how the level of independent oversight can limit adverse cover-pool management by the issuer in times of stress.

Comprehensive but old legal framework...

The legal framework for Hungarian covered bonds (jelzáloglevél) is based on the Mortgage Bank Act as well as accompanying sections in the Banking Act[11].

The Hungarian covered bond framework only allows specific mortgage banks (Jelzalogbank) to issue covered bonds. Since established in 1997, it has seen only limited changes to its structure. The specialist banking principle facilitates asset segregation and the Act ensures that there is no acceleration upon default (and there are no cross-default clauses in case the parent of the mortgage bank defaults).

… allows for segregation and payment continuity.

The framework also requires a special cover pool administrator which latest upon the insolvency of the issuer is tasked to ensure timely payment on the covered bonds and is allowed to sell or transfer parts of the cover pool to facilitate timely payment.

Ongoing oversight is split between an external trustee (typically an auditor) appointed by the MNB to ensure compliance, as well as additional powers by the MNB. Among other things, this allows the MNB to intervene early (i.e. appoint a special cover-pool administrator even before insolvency proceedings are initiated).

[10] For further details see Scope's Covered Bond Methodology available here

[11] Act No XXX of 1997 on Mortgage Banks and Mortgage Bonds (Mortgage Bank Act) and some rules on the establishment, supervision and liquidation of Mortgage Banks – Act No CXXXVII of 2013 which can be retrieved here

…but is light on liquidity and market risk.

Comparing with the European covered bond directive we expect harmonisation to improve the framework with regards to market and liquidity risk containment – where it is currently light.

Most programmes today provide investors with more than the current minimum over-collateralisation (OC). As such, the introduction of a 5% minimum OC as per the directive as well as the provision of a mandatory 180-day short-term liquidity buffer should not provide a lot of controversy. Coupled with improved liquidity management, this will improve the current framework.

Soft bullet structure or CPTs could mitigate mismatch and illiquidity risk

With limited secondary market liquidity in Hungarian mortgages, we also expect intensified discussion on the role of extension features, including soft bullets but also conditional pass through (CPT) structures, once a consultation becomes available.

Additional mandatory transparency will be needed to be included into the law – but is already provided regularly by most issuers.

Some more technical aspects such as the allocation of proceeds for the wind down of the cover pool will likely be pasted in once a harmonised European interpretation becomes available.

The current Hungarian covered bond framework does not significantly differ from most existing frameworks. It already has a solid basis to allow for a rating differentiation to the issuer but it will nonetheless benefit from harmonisation.

Combining the existing framework with existing not legally-binding market practices, we envisage that Hungarian covered bonds will very likely be able even today to receive the full two-notch rating differentiation for a supportive legal framework under our methodology.

At the latest once it is aligned with the directive, remaining uncertainties should be removed and firmly support the current “just-about” meeting of the provisions expected for full uplift.

Less common features in the current framework:

Pooling of cover assets works !

Introduction of the MAFR prompted pooling…

The current framework is one of the few where a pooling of cover pool assets is not only available in theory but also works in practice.

Owing to the structure of the co-operative banking sector, we observe functioning intra-group pooling. Takarek mortgage bank, for example, pools cover assets originated by member banks within the sector’s mortgage bank.

MAFR also prompts banks that do not have their own mortgage bank to seek access to covered bond refinancing.

Unlike Norway, where a group of banks with similar business focus jointly own a covered bond issuer to pool their mortgage loans and refinance them, we observe a different set-up in Hungary. Here a bank with mortgage loan origination might sell its mortgages to a competitor’s mortgage bank that then refinances via covered bonds.

Direct and indirect transfer of mortgages

..and banks use different ways to transfer cover assets

In Hungary, mortgage banks might also directly purchase a mortgage with the accessory mortgage security from other banks. The mortgage loans then become accounted and serviced by the mortgage bank.

The mortgage bank might also purchase mortgage liens, which is the most common transfer used for banks not belonging to the same group. The seller can maintain its customer relationship, continue to service the loan and account for it on its balance sheet.

Further, unlike the true sale of the mortgage loan, the mortgage banks benefit as they are not exposed to the credit risk of the borrower. The bank selling the mortgages will have to make-whole in case the borrower defaults.

For the latter and similar to French covered bonds issued via SFHs, the transfer of collateral is only perfected in case of the insolvency of the seller and is ensured by law.

Harmonisation will allow Hungarian CBs to achieve the “Premium” label

We expect Hungarian covered bonds – following the likely uncontroversial amendments needed – to be able to become “Premium” covered bonds as per the European covered bond definition. As such, international investor appetite should increase and further help to grow the market.

Asset eligibility

Framework expects prudent valuation of collateral

There are no credit-negative aspects that differentiate Hungarian asset eligibility definitions. With a 70% LTV limit for residential mortgages, the Hungarian framework does not currently make full use of the maximum LTV possible under the directive. We note positively that valuations are not based on market values but a conservatively-established mortgage-lending value. This is hardly surprising as the framework is based on the German Pfandbrief blueprint. This provides an additional buffer against potential market-value declines which in some parts of Hungary are currently elevated. We also view positively that in case of the insolvency of the issuer, the whole loan and not only the eligible portion becomes part of the cover pool.

The Hungarian framework allows for the use of substitute assets but has a unique twist. Upon insolvency, other not (yet) registered or even ineligible assets residing on the balance sheet of the mortgage bank will also become part of the cover pool and enhance liquidity.

Hungarian covered bonds benefit from standing in resolution. Systemic importance is increasing.

Scope also incorporates into its fundamental credit support (the first pillar establishing the minimum credit differentiation between the issuer and covered bonds) the likelihood that an issuer can maintain its covered bonds as a going-concern funding instrument.

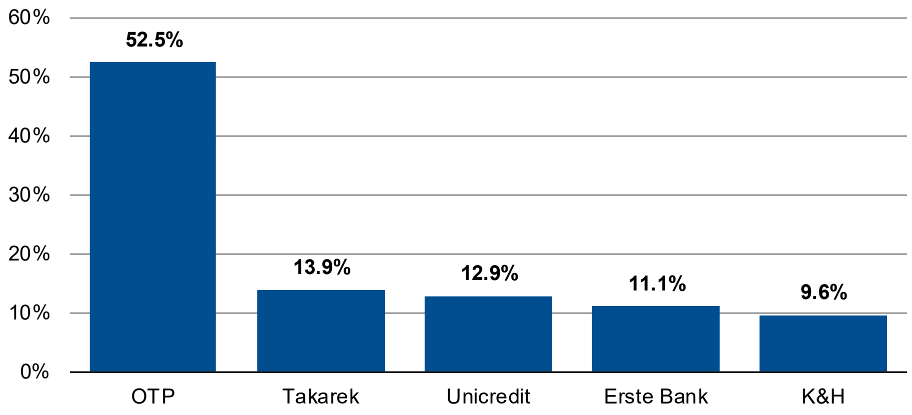
This building block analyses the status of covered bonds upon regulatory intervention as well as aspects that could incentivise stakeholders to support covered bonds – among other things because of the systemic importance of the issuer and the relevance of covered bonds as a refinancing instrument.

Covered bonds would not be impacted by a bail-in

Generally, Hungarian covered bonds are not impacted in a potential bail-in scenario. They currently meet the pre-requisites and the covered bond harmonisation is not likely to change this, adding one additional notch of uplift for all Hungarian covered bonds from resolution regime analysis.

One additional notch might also be provided because of the need for mortgage bank refinancing according to the MAFR requirement. We believe the high home ownership rate combined with increased financing needs for apartments and houses speaks to a strong incentive to maintain covered bond issuers as going concerns. This should also hold true in case of non-viability of the parent where its restructuring will more likely than not result in the maintenance of the covered bond issuer.

Figure 5: Hungarian Covered bond issuers as at June 2020 (EUR 3.9bn)



Source: Refinitiv, Scope

Systemic importance of covered bonds is set to further increase and already strong.

Importance and usage of covered bond funding is increasing

With about 3%, the systemic relevance of covered bonds appears low when taking the share of outstanding covered bonds compared to GDP as a proxy. In light of the low average leverage of Hungarian homeowners mentioned before, the relevance of covered bonds has gained significance, however.

We will closely monitor harmonisation discussions to assess the cohesiveness of stakeholders and how differences in views are resolved. As mentioned, the MNB is a significant stakeholder but also supporter of the covered bond market. At the same time, the market is highly concentrated (see Figure 5). All the major banks have their covered bond banks; difference in market shares between the parent and the mortgage bank reflect the sourcing of cover assets from banks outside of the group.

Summing up

Hungarian covered bond market likely to grow further

Strong macroprudential oversight has significantly reduced the risk of Hungarian covered bonds compared to the first time they appeared internationally. Availability of green collateral coupled with a brushed-up covered bond framework and the ability to lift the credit quality of covered bond ratings significantly above the issuer rating will be additional supporting elements once Hungarian covered bonds re-enter international markets.

Attracting additional investors will help issuers to diversify their investor base/ funding mix and new investors will benefit from a spread premium –typical for nascent markets but not necessarily because of heightened risks.

Highest ratings achievable and no constraint from sovereign ratings

We currently envisage the possibility of a fundamental support-based credit differentiation of between four to five notches to which up to three additional notches for cover pool support could be added. Once harmonised, this uplift could increase even more.

In combination, investment-grade Hungarian banks could see their covered bonds achieving very high credit quality; over time even the highest credit quality.

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