Discussion material

The Magyar Nemzeti Bank (the National Bank of Hungary; MNB) has pointed out the increasingly high risks related to FX lending on numerous occasions for several years now. The adverse consequences of FX lending have increased the country's vulnerability significantly; therefore, the MNB urges the soonest possible introduction of regulation. Constraining the risks posed by FX lending to households is in line with the current efforts of the European Union. Both the European Commission and the European Central Bank (ECB) have recently pointed out the risks of FX lending and the need to constrain these risks.

Over the past years, Hungarian households have incurred FX-denominated debt to a large extent. Demand for FX loans was driven by expectations for a fast convergence of income, by lower interest rates on FX loans compared to HUF loans and by the relative stability of the forint's exchange rate. Strong competition among banks, which led to the introduction of increasingly risky FX (EUR-, CHF and JPY-denominated) loan products, and an abundance of financing available abroad resulted in a fast indebtedness in foreign exchange denominated loans. Lending conditions also became increasingly lax so much that at the end of the period, mortgage loans were available against a 10% down payment or no down payment at all; furthermore the presentation of a proof of income from the employer was no longer a condition either. This, in turn, further boosted the demand for loans and hence, the total volume of loans that banks could sell. In 2008, already 80% of the household loans were FX loans. Currently, the household loan-to-GDP ratio is standing at 40%, and the overwhelming majority, nearly 60%, of the household loans are CHF-denominated.

FX lending carries both specific and systemic risks. Specific risks (risks at the level of the individual banks) arise from the fact that risks are inadequately assessed. Encouraged by loose credit standards and a relatively stable HUF exchange rate individuals are inclined to take on debt service that they can hardly afford to service. As a result, they become heavily indebted, with no savings to rely on when exchange rate fluctuation or interest rates increase. This may, in turn, increase the probability of a future default. The fact that the debt service obligation of Hungarian households accounts for 13% of their disposable income, well over the euro zone average, suggests a very high degree of indebtedness. The payment-to-income ratio is around 20% in the case of debtor households; this ratio is even higher, approximately 22%, in the case of debtor households in the lowest income category, with hardly any savings to tap.

Specific and systemic risks, affecting the economy as a whole, combine to exert an aggregate impact on the financial system. The disproportionate indebtedness of households, a high degree of the vulnerability of FX loans' probability of repayment to exchange rate changes and the banking sector's rollover risks all add to the vulnerability of the country and increase the financing costs of Hungary's sovereign debt significantly. These risks also limit monetary policy's room for manoeuvre.

In order to reduce these risks, regulatory intervention is necessary. The regulation recommended by the MNB are aimed at the tightening of the risk policies of the individual banks and lending conditions including the limiting of the payment-to-income ratio (PTI), the loan-to-value ratio (LTV) and, the maturity of car purchase financing.

To prevent disproportionate indebtedness, the cap on the affordable PTI, which in the case of HUF loans, would be at most 30% of the net average income of a household with two wage-earners, mitigates the risks run by the bank as well as the client. This 'cap' could be raised in the case of households in the higher income categories, as their savings are probably more sizeable.

Regarding default on secured loans, the maximum LTV reduces the risks of the banks. In setting a limit for the LTV ratio, the volatility of the market price of the collateral and the risks arising from potential fire sales should be taken into account. Based on this, in keeping with international practice, 70% of the

prevailing market value seems to be an acceptable and reasonable LTV ratio in the case of HUF mortgage loans. The corresponding figure for car purchase finance is 80%.

Compared to HUF loans stricter credit conditions on FX loans are justified by the risks due to exchange rate fluctuations, thus PTI and LTV limits on EUR and other foreign currency loans should be lower relative to HUF loans,.

Due to the financial crisis the growth of the FX loan portfolio has slowed down and the share of HUF loans has increased. Therefore, the introduction of the above limits is unlikely to affect the performance of the banking system or the economy significantly. Since past experience suggests that FX lending may pick up abruptly again, it is important to introduce the regulation as soon as possible. The MNB has sent the proposed concept for the regulation and the accompanying impact study to the Ministry of Finance. According to the impact study, the proposed limits to PTI and LTV ratios would slow down the recovery somewhat in the short term. However, the composition of growth would show a more balanced pattern, the risks facing households would be lower, and consequently, the country would become less vulnerable, due to a lower current account deficit. That, in turn, would make it possible to reduce the interest rate differential between the forint and the euro, and would contribute to faster growth over the longer term.

It is the Ministry of Finance that has the requisite powers to decide on the regulations of FX lending, as, regarding this issue, the Government may issue a decree or submit a draft legislation to Parliament. The MNB is ready to consult on the proposal with other institutions responsible for financial stability as well as with market participants.

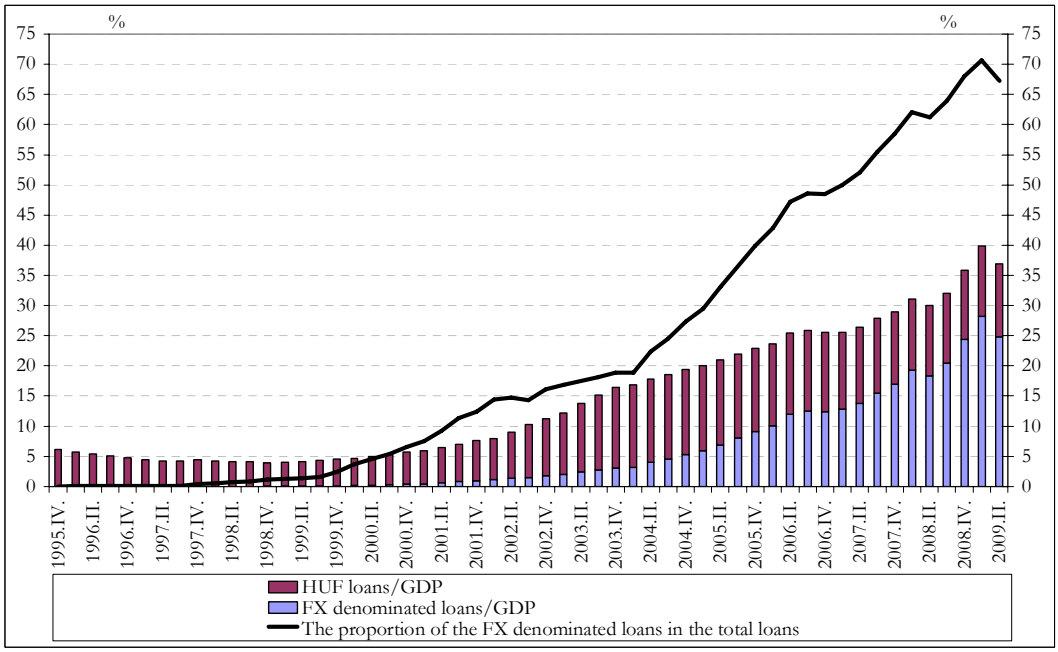
Summary of the MNB's proposal

	Currency	**MNB proposal**		
For all types of household loans		**Up to HUF 250,000 monthly net income***	**Up to HUF 500,000 monthly net income***	**From HUF 500,000 monthly net income***
Maximum payment-to-income ratio	Forint Euro Other currency	**30 per cent** **23 per cent** **15 per cent**	**40 per cent** **31 per cent** **20 per cent**	**50 per cent** **38 per cent** **25 per cent**
For household mortgages Maximum loan-to-value ratio	Forint Euro Other currency	**70 per cent** **54 per cent** **35 per cent**		
For car purchase financing Maximum loan-to-value ratio	Forint Euro Other currency	**80 per cent** **62 per cent** **40 per cent**		
Maximum maturity of car financing: **5 years**				

N.B.: * The income limit applies to the entire household (incomes are added together in the case of two wage-earners).. Limits on EUR loans are based on the PTI and LTV limits of HUF loans divided by 1.3 to take into account exchange rate risks. In the case of loans other than EUR loans, the PTI and LTV limits of HUF loans are to be divided by 2. The LTV limit is based on the market value of the collateral. Down payment is 100%-LTV.

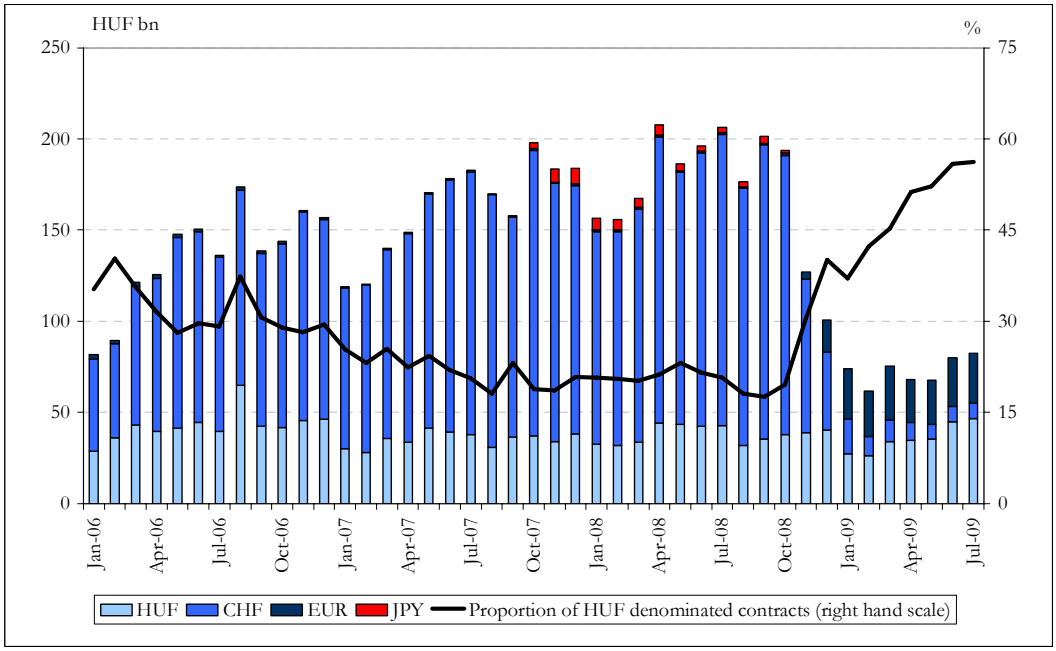
Figures

Figure 1: The composition of household loans by currency



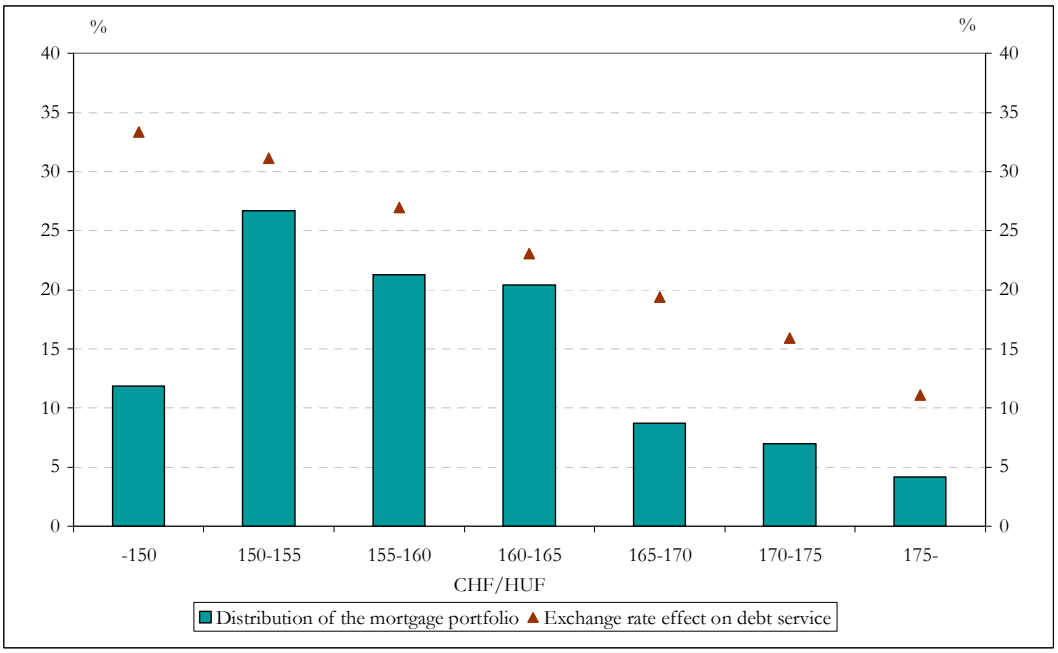
Source: MNB.

Figure 2: The currency composition of new household loans from banks



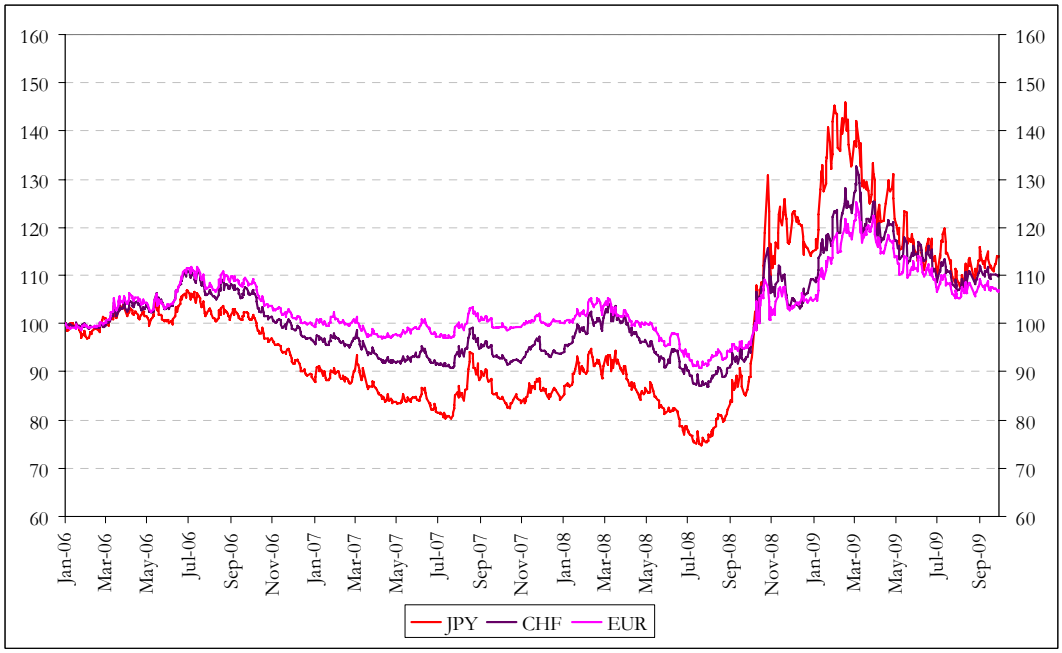
Source: MNB.

Figure 3: The distribution of foreign currency loans of households by exchange rates at the dates of loan approval and the impact of forint weakening against the Swiss franc at CHF/HUF 200 on instalments



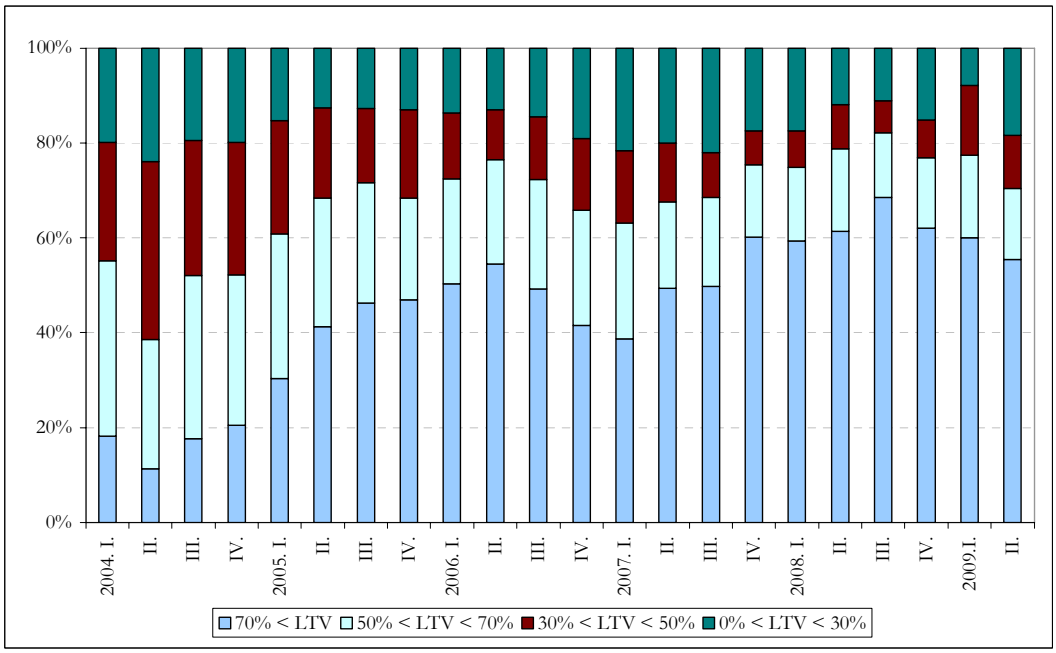
Source: MNB survey.

Figure 4: The changes in the Euro, Swiss Frank and Japanese Yen (2006 January=100)



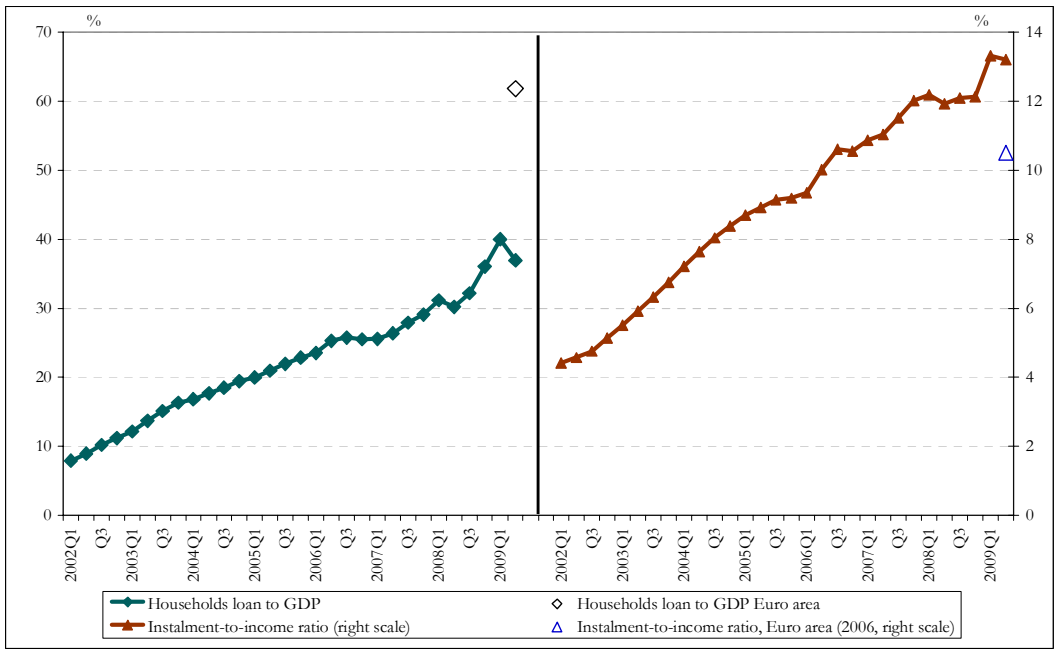
Source: MNB.

Figure 5: The distribution of LTV of households' new housing loans



Source: MNB.

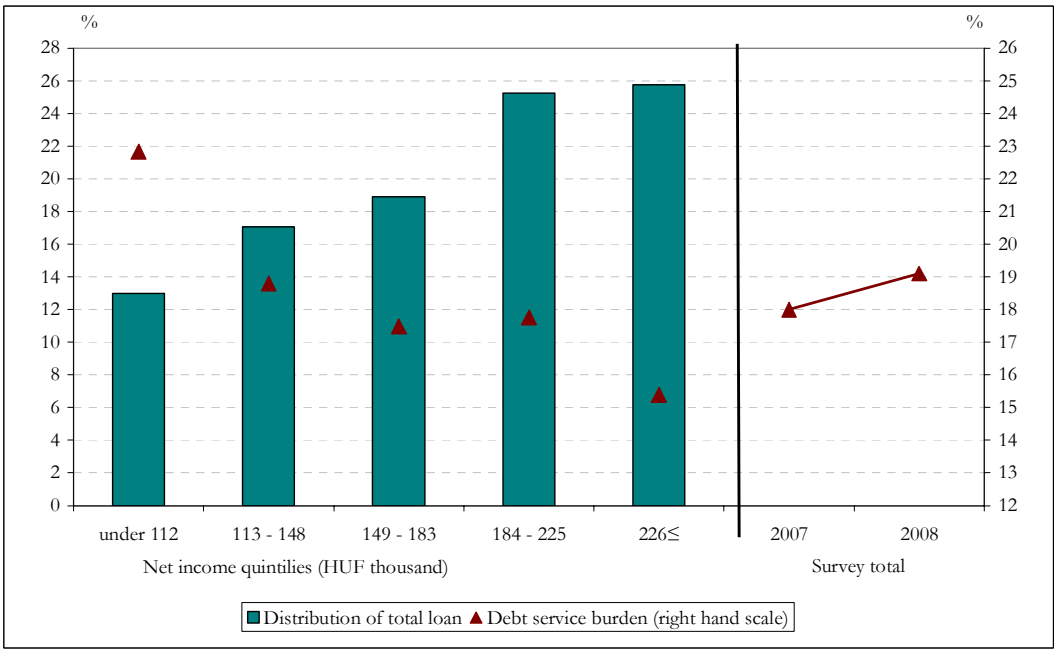
Figure 6: The indebtedness and debt service burden (installment to the income ratio) of the households



Note: All households.

Source: MNB.

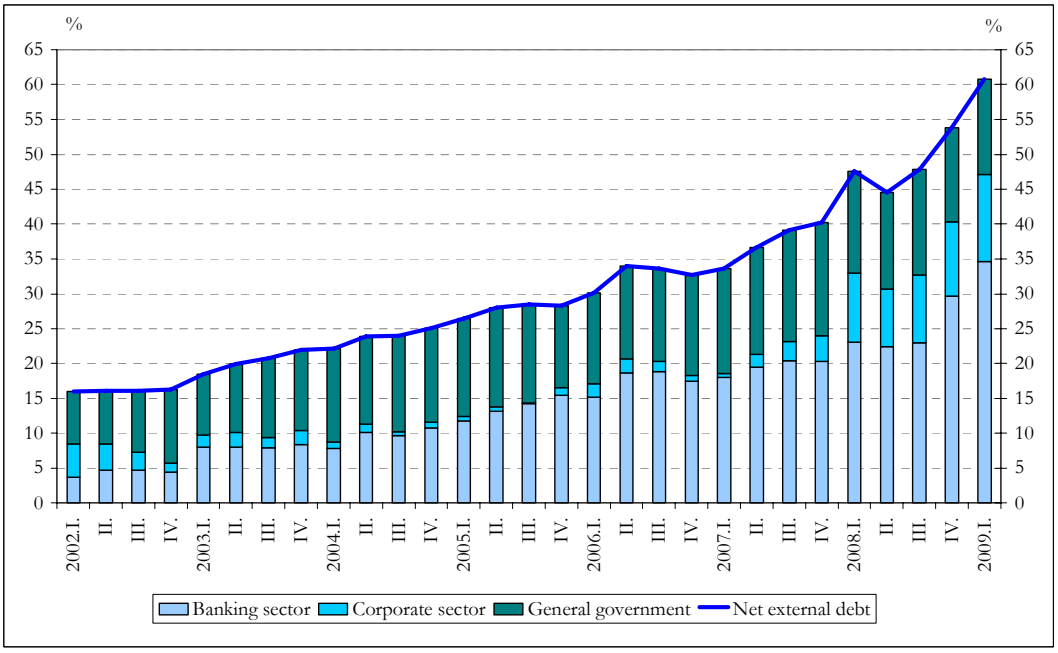
Figure 7: The distribution of total loan and debt service burden (installment to income ratio) by income quintiles



Note: Households having loans.

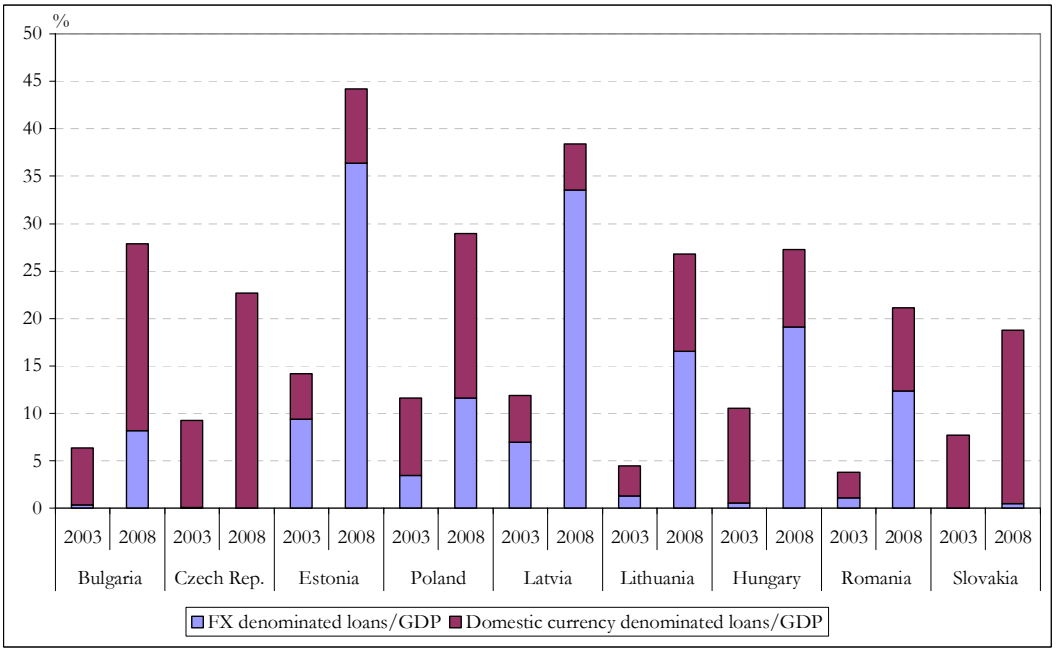
Source: MNB survey.

Figure 8: Net external debt as a percentage of GDP



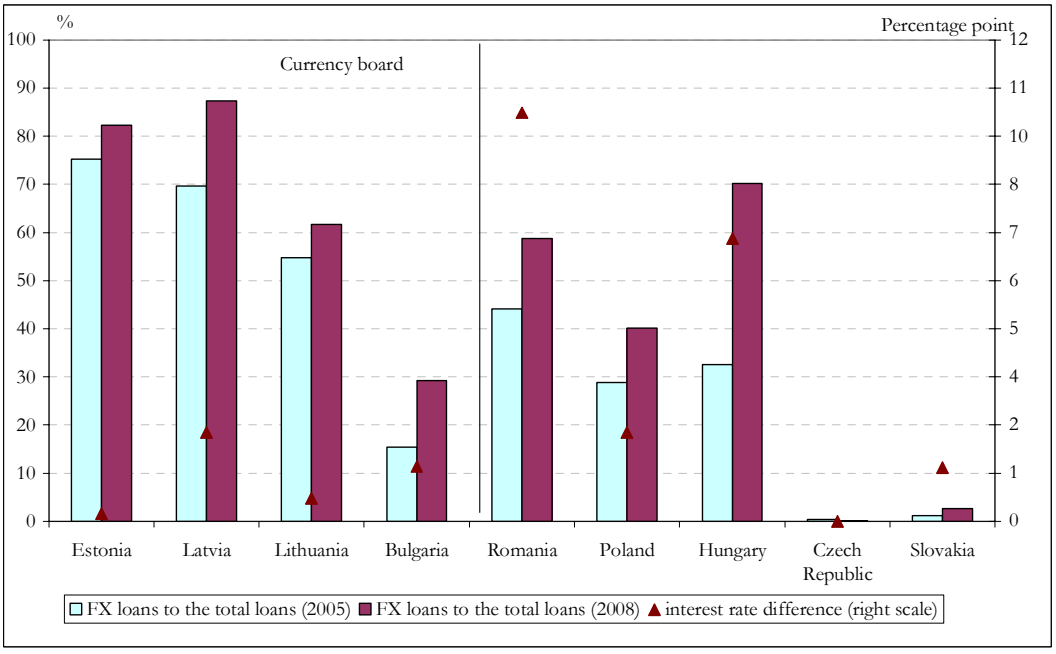
Source: MNB.

Figure 9: The composition of household loans from banks by currency in the CEE countries



Source: National central banks.

Figure 10: FX loans to the household sector loans in the CEE countries' banking sectors



Note: Interest rate differential = domestic 3-month interbank rate – 3-month EURIBOR (average for 2005-2008 period).

Source: National central banks.