AEGON Asset Management

Monthly analysis – February & March

A revival on the mortgage market?

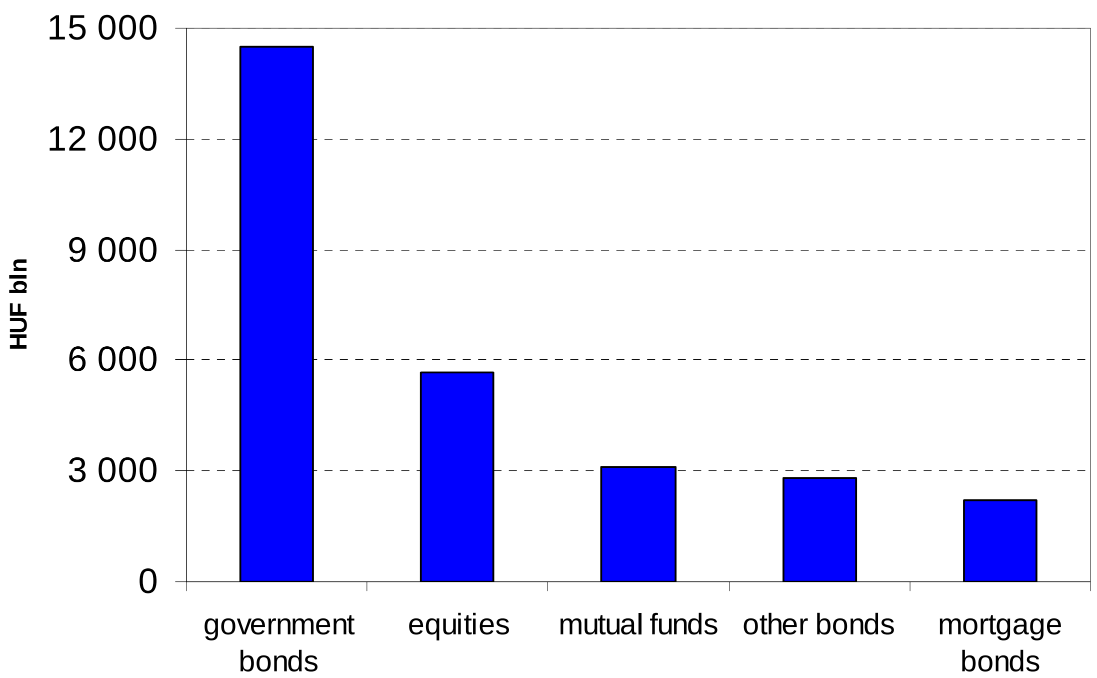
At the start of February the National Bank of Hungary (MNB) announced that it would launch a programme to support the development of the forint mortgage loan and mortgage bond market, and the first buyback auction was duly held on 10 March. In this regard, our aim here is to outline the current status of the mortgage bond market in Hungary, to discuss the motivations that drive players in the market, and to assess the possible impact of the announced MNB programme.

The MNB's announcement of 10 March 2010 stated: "Market players submitted bids totalling HUF 21.5 billion in the secondary market purchase tender for mortgage bonds held for the first time by the MNB on 10 March 2010, with offers received for nine of the ten advertised mortgage bonds. Taking into account the information on secondary market prices at its disposal, the MNB adjudged that the bids were significantly less favourable than market yields, falling at least 50 basis points short of the latter, and for this reason it declined to accept them and declared the tender unsuccessful."

Will the MNB hold a mortgage-bond buyback auction? Has it joined the ranks of larger central banks in belatedly following the Fed and the ECB? For those who do not follow developments on the Hungarian bond market, the news may appear surprising at first; nevertheless, let us examine the considerations that guide the domestic central bank.[1]

Figure 1

Portfolio of securities held by players in the economy, Q4 2009 (MNB)



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[1] The structure of the market from the regulatory point of view was presented in depth in an analysis by Mónika Papp (The conditions of mortgage bond-based financing in Hungary in terms of financial stability, MNB Workshop Studies 36, 2005). Our aim is to approach and update the topic more from the investor side.

At the beginning of February the MNB announced that it would launch a programme to support the development of the forint mortgage loan and mortgage bond market. Mortgage bonds are important instruments from the point of view of issuers, because banks have no other means of securing forint funds for the medium and long term.

Retail deposits are short term, and interbank financing is also typically of less than one year's maturity, while credit institutions tend to concentrate on foreign currency in the case of syndicated loans. For investors, meanwhile, mortgage bonds can be advantageous because their generally long maturities may be offset by the covered nature of the bonds and the yield premium they offer.

The development of the domestic mortgage bond market is closely interlinked with the evolution of the housing subsidy system, as the appearance of funding-side assistance made it worthwhile for banks to issue mortgage bonds. However, with the continuous narrowing of subsidy opportunities and with the forint/foreign currency interest differential stabilizing at a high level, foreign currency loans have increasingly taken over as the principal form of home loans, thus leading to a deceleration in the initial dynamic growth of the market.

At first glance mortgage bonds still constitute a significant portion of the entire portfolio of securities held by market players, as their outstanding stock is not much lower than the entire combined assets of domestic investment funds, although the difference remains significant compared to government securities (forint and foreign currency combined).

Face value of outstanding mortgage bonds on 1 March 2010 (HUF/EUR/CZK million)				
	OTPJB	**FHB**	**UCJB**	Total
HUF	826 031	234 305	32 730	1 093 066
EUR	3 000	864	15	3 879
CZK		454,5		455

Issuers

There are two significant players on the Hungarian mortgage bond market: OTP Mortgage Bank and FHB Bank. Unicredit Mortgage Bank is also present on the market, but the quantity of its outstanding bonds and their active role on the market cannot be compared to those of the two leading issuers. OTP Mortgage Bank accounts for around three quarters of the market, while FHB has a market share of 21%-22%.

Previously, mortgage bond issues were typically of 10 years' maturity, while a number of bonds were also issued with terms of 15-16 years. In recent years, however, maturities have tended to become shorter as decreasing forint lending has reduced banks' need for long-term funds, while investor demand has also tended to become stronger in the shorter-term segment.

Secondary market

Activity on the secondary market in mortgage bonds falls significantly short of the level its size would justify, for which there may be several explanations. One reason is that the domestic institutional players that provide liquidity on the secondary market hold proportionately far fewer such securities than they do, for example, government bonds, while daily liquidity is largely provided by these same players (or by asset managers acting on their behalf) on the government securities market as well.

Although the stock found on the books of commercial banks is significant, this is undoubtedly distorted by the fact that a large proportion of the HUF 1,000-billion portfolio is not to be found in "real" trading books but in the form of securities issued by OTP Mortgage Bank and subscribed by OTP Bank. It can be supposed that a large part of the stock in the hands of non-residents actually takes the form of long-term investments, and that foreign investors rarely appear on the secondary market.

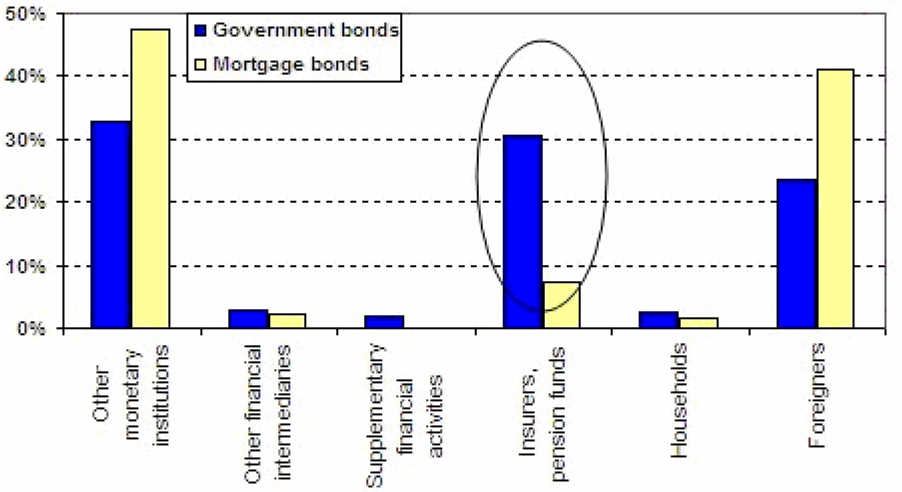
In the case of OTP securities, there is thus virtually no liquidity on the secondary market for forint-based products, with bonds largely either on the books of the parent bank or in the hands of other long-term investors. Meanwhile, we can speak of a secondary market for three of the euro-denominated securities, for which foreign investment banks also continuously quote prices in addition to the parent bank. In the case of FHB securities we do not generally encounter firmly quoted prices, and information on premiums can mainly be gleaned at the time of their primary issue.

So why are domestic institutional investors not buying mortgage bonds in greater quantities? There are several reasons. First, they lack the necessary mandate to do so, as the clients of asset managers typically tend not to want to hold a portfolio that follows an investment strategy of this kind. Second, there is no mortgage bond index that can be followed and which might be incorporated into benchmarks (no great surprise given that it could only include a handful of bond series, of limited liquidity, issued by a total of three issuers). However, neither is there a mixed corporate bond/mortgage bond/government securities market index. And perhaps most importantly, market price quotations are limited even for somewhat liquid securities, making it difficult to appraise their value or measure their performance. Consequently, for want of a better evaluation, asset managers are inclined to regard mortgage bonds merely as an element that spices up a portfolio, and are glad if they can buy them at a high premium, but tend not to buy them in larger batches for fear that the difficulties in evaluating them will leave their mark on performance.

Of course this creates a vicious circle: asset managers do not invest in mortgage securities as long as there is no improvement in secondary market liquidity, and of course there is no reason for it to improve as long as investors stay away. From this point of view, the announced MNB programme may help the market considerably.

Figure 2

Distribution in ownership of government securities and mortgage bonds, Q4 2009 (MNB)



Pricing

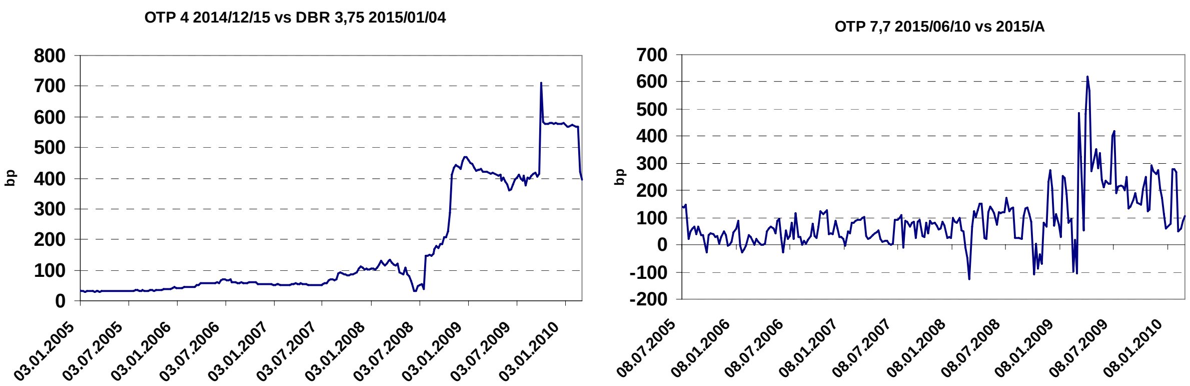
Spreads significantly widened at the end of 2008 and in early 2009 due to concerns in both the sector and in connection with the country as a whole, and are only now beginning to stabilize and gradually drop back to normal levels. Primary market activity in this period was minimal and issuers have only begun to return to the market since the end of last year.

OTP Mortgage Bank most recently issued securities at the end of 2009, but this issue was essentially private as OTP Bank subscribed the forint-denominated bonds of 16-year maturity, with an approximately 170-180 basis-point spread above the 2023/A series government bond. Forint-denominated securities maturing in 2015, based on OTP Bank's price quotation, are currently in circulation at a 200-220 basis-point premium, but there is no liquidity in these bonds and the graphic below at best demonstrates the direction of movement of the price premium.

Of the euro-denominated securities, those of a shorter maturity (1.5 years) are currently in circulation at a 330 basis-point premium compared to German government securities and a 260 basis-point premium over Euribor, while the respective premiums in the case of bonds of a longer maturity (4 years) are 485 basis points and 400 basis points. (In the case of the foreign currency-based securities, the higher premium derives largely from the so-called base effect, and so when re-hedging into forint much of the higher spread disappears.)

Figure 3

Premium on a forint-denominated and a euro-denominated OTP mortgage bond compared to the benchmark government security



(Source: Bloomberg, based on OTP Bank price quotation)

In the case of FHB, we can gain a better picture of the spreads at auctions. In November the bank was still issuing a 5-year covered HUF bond at above 200 basis points, but by the time of a later auction at the end of the month the issuer no longer accepted a single offer at such levels.

MNB programme

On 8 February the MNB announced that it would purchase HUF 100 billion in forint-denominated mortgage bonds on both the secondary market and at primary issues, provided the given issue is suitably liquid and its price quotation on the secondary market is assured.

This may be a first step towards activating the market and further decreasing premiums. At a fresh FHB auction held after the announcement, the premium declined by approx. 50 basis points. Accordingly, prices on the market reacted to the news by showing a slight rise.

Fresh details have since been made public. MNB will buy bonds in primary issues provided that the given bonds have a term to maturity of at least 3 years, at least HUF 50 billion are planned to be issued within one year, and at least three market-makers undertake to quote a bilateral price for a batch of HUF 100 million, with a 75 basis-point spread in the case of smaller series and a 50 basis-point spread for larger series. In secondary market tenders, securities designated by the MNB may be sold to the central bank, which will decide at its own discretion on the prices to be accepted. The failure of the first secondary market tender nevertheless indicates that even the MNB will not buy back securities at a very expensive price, and that it has an idea of what constitutes a fair market premium. On the other hand, it seems that supply on the secondary market at the hitherto seen premiums is almost negligible.

At first reading the size of the programme is not significant, given that it represents around a mere 10% of the entire stock of mortgage bonds. However, if we disregard the securities lurking on bank books, thus taking only the "free float" as a benchmark, then this proportion is substantially greater, reaching as much as 30-40%.

One of the goals of the programme may be precisely to coax dormant bond series from bank books, thus generating space for new issues encouraged by the programme.

Another important goal of the programme is for the conditions it creates to provide a positive boost to the secondary market. The larger series and compulsory price quotation (even if it may be only a stock exchange quotation) undeniably point in this direction. OTP will probably be more easily able to take on a HUF 50 billion series, while FHB – which is more active on the "real" market – may have a harder time of it. But in all probability maturing securities (HUF 18 billion this year, and HUF 21 billion next year) will be refinanced in a far more concentrated manner.

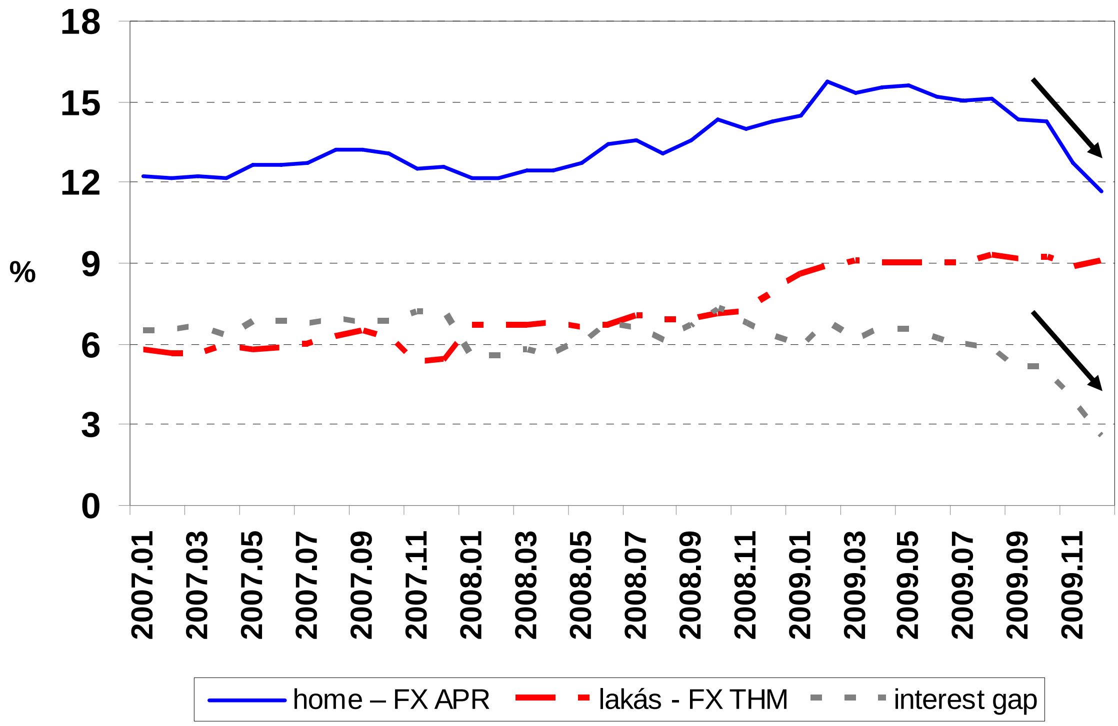
Of course the credit demand side is presently also experiencing problems, as the economic and financial crisis has decreased the appetite for borrowing to a minimum worldwide. The institutional foundations for providing forint loans must nevertheless be laid in good time, lest failure to do so should prove an obstacle to banks' satisfying credit demand in forint as it returns to normal levels in the future. One step towards ensuring this is the new legal regulation that entered into effect on 1 March, which, by permitting a much higher LTV value (75%) for forint home loans than in the case of foreign currency loans (EUR – 60%, CHF – 45%), will similarly drive borrowers towards the forint.

What, then, are the most important conditions for this? On the supply side, there is a need for institutional investors to enter the market with a greater degree of interest than before, which requires bonds to be issued on the market in larger series than previously. Secondary market liquidity, which may be helped by the compulsory price quotation prescribed by the MNB programme, is indispensable. As the market develops, the introduction of a domestic mortgage bond index could also come under consideration in future. Increasing numbers of issues and issuers are essential to this end. There is a sentence in the MNB announcement which may give cause for optimism in this regard, namely the one stating that "…over the course of the year, the MNB will initiate further steps in the interest of developing forint mortgage lending. These (…) will target a broadening of the circle of those authorized to issue mortgage bonds." We think it conceivable, therefore, that it will no longer be necessary to establish a separate, specialized credit institution in order to issue mortgage bonds, and that even commercial banks may have this opportunity in future – as they do in Germany, for example.

On the demand side the most important thing is that forint interest rates continue to fall. The MNB programme is able to contribute to this by reducing premiums through the creation of a more active secondary market. In recent months long-term forint yields/interest rates have decreased to acceptable levels, and the average APR on forint home loans is now on the verge of being competitive with that on foreign currency loans. However, premiums still constitute 10-20% of the total cost of the loan. With a view to further improvement, we consider it a very favourable move that the MNB is helping to create a (more) practicable secondary market as this is an important step in further reducing premiums, which, in addition, may also further improve the competitiveness of forint home loans.

Figure 4

APR on forint and foreign currency-based home loans, and the difference between the two (MNB)



If forint home loans at affordable rates of interest become available once again then new issues will follow, and, as bond series swell to a reasonable size with continuous price quotation, institutional investors, who have stayed away until now, may once again be attracted to the mortgage bond market. The rest depends on those responsible for economic policy: fiscal discipline might help further reduce long-term interest rates, while the creation of a much more restricted and better-targeted interest subsidy system, tailored to the budget's load-bearing capacity, might also have a catalyzing effect.

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