The Development of the NPL Market in Hungary

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The problem

After a number of years of anticipation, 2016 saw a number of large non-performing loan portfolio sales in the Hungarian market.

Following the collapse of communism in 1989, Hungary was quick to introduce market reforms. Widespread privatization opened the market to large scale foreign investment. Although Hungary retained the Hungarian forint (HUF) as its national currency, capital controls were gradually lifted throughout the 1990's ending completely with Hungary's accession to the EU on 1 May 2004. Membership of the EU and NATO promised political stability and security and Hungary became highly integrated into the global economy.

As a result of such a high level of integration, Hungary suffered badly during the global economic crisis. Levels of private debt denominated in foreign currencies were particularly high with up to approx. 70% of residential mortgages denominated in foreign currency (90% in Swiss Francs (CHF) and 7% in Euros (EUR)). The Hungarian government's response to the crisis involved a bank levy and a number of measures designed to protect local borrowers. These measures exacerbated the constraints on borrowers' ability to access new finance for their existing indebtedness and left many commercial banks holding large portfolios of distressed debt.

By the end of 2015, non-performing loans in Hungary amounted to EUR 5.1 billion, equivalent to a NPL ratio of 11.7% and a NPL coverage ratio of 69.2%.[1]

A change in approach by the Hungarian authorities, greater focus on the issue by market participants and a welcome upswing in the Hungarian real estate market laid the foundations for significant improvements in this position during 2016.

Hungary's response

The Hungarian National Bank ("MNB"), the central bank and primary banking sector regulator of Hungary, identified distressed debt as a key concern for the Hungarian banking sector and has taken a number of measures to ensure that local banks address this issue. The MNB, with support from the European Bank for Reconstruction and Development ("EBRD"), identified three interlinked areas in which changes could reduce the threats to the Hungarian banking system posed by high levels of NPLs:

1. **Regulatory encouragement** – measures to encourage banks to address the problem of NPLs on their balance sheets (and remove obstacles to them doing so);
2. **Improving tools for resolution of NPLs** – improving the legal environment for the efficient resolution of non-performing loans including reversing measures which impeded the enforcement of security, introducing reforms of insolvency and bankruptcy law and the encouragement of the use of out-of-court resolution mechanisms; and
3. **Creating a market for NPLs** – removing obstacles to the establishment of a liquid market for the trading of NPLs.

Measures to implement such changes have had limited success, but, fortunately a buoyant real estate market has led to an increase in NPL sales and a significant decrease in the NPL portfolios[2] over the last year. Such sales in themselves have increased the experience of market participants and given investors greater guidance as to price, which has further improved the conditions for the development of an NPL market.

The NPL market today

2016 saw a series of high profile portfolio sales, including the sale of remarkable portfolios of commercial mortgage backed loans by CIB Bank Zrt. and Raiffeisen Bank Zrt. and the sale of a high value portfolio of residential mortgage backed loans by Erste Bank Zrt. In addition there have been a number of off-market sales of high profile individual non-performing loans e.g. the sale by MKB Bank of a significant loan to Lone Star, a Texas-based distressed debt specialist.

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Although a number of banks (e.g. Erste and Raiffeisen) are nearing the end of this process, other banks have yet to fully address their portfolios of distressed debt. We anticipate that some of these loans will come to the market in the near future – either directly or through MARK Zrt. (see below).

Regulatory encouragement

MNB identified non-performing loans (particularly in the real estate and project finance areas) as representing a systemic risk to the Hungarian banking market and informed the Hungarian banks of its intention to address this risk by requiring the banks to maintain an additional systemic risk buffer as part of the minimum capital requirements for banks regulated by MNB. The imposition of such an additional systemic risk buffer is permitted by (i) Section 92 of the Banking Act; (ii) Section 35/A of Act CXXXIX of 2013 on the National Bank of Hungary; (iii) Regulation EU No 575/2013 of the European Parliament and of the Council (CRR); and (iv) Directive 2013/36/EU of the European Parliament and of the Council (CRD IV).

As of 1 January 2017, MNB passed a general decision prescribing the creation of a systemic risk buffer to credit institutions operating in Hungary and to groups involving a credit institution, which are supervised by the MNB on a consolidated basis. In MNB's view, the systemic risk buffer increases the shock-absorbing capacity of the institutions not curtailing their risky exposures on one hand and it may encourage the reduction and cleaning of the stock of risky exposures within a reasonable timeframe on the other hand.

The rate of the systemic risk buffer depends on the ratio of the gross stock of problematic exposures to the domestic Pillar I capital requirement imposed on the credit institution (or on the group subject to consolidated supervision). If this stock exceeds 30 per cent of the capital requirement and is greater than HUF 5 billion, the systemic risk buffer is set at or above 1%, but the systemic risk buffer rate cannot be higher than 2%. The exact rate of the systemic risk buffer is determined by individual MNB decisions annually, based on the information reported by the respective credit institutions (groups).

Improvements in resolution of NPLs

The extent to which NPLs can be efficiently resolved by the originating banks (or by NPL purchasers) is significantly influenced by the legal framework governing the enforcement of security, bankruptcy protection and insolvency.

Changes relating to residential mortgage loans
The Hungarian authorities have taken steps to improve the ability of creditors to resolve non-performing residential mortgage loans, including by reforming the following areas:

— **Extraordinary moratorium**
Following the financial crisis, the Hungarian authorities took a number of measures to mitigate potentially critical effects of loan default on the domestic housing market. These included redenomination of residential mortgage loans into Hungarian forints and an extraordinary moratorium on eviction from residential properties.

Hungarian law imposes a general winter moratorium on eviction from residential properties during the period 1 December and 1 March each year. Following the financial crisis, an extraordinary moratorium on eviction was imposed which prevented eviction from residential properties at any time. The extraordinary moratorium was relaxed in September 2015 and ended on 31 December 2016.

— **Minimum enforcement price**
When removing the extraordinary moratorium, however, the Hungarian government introduced stricter requirements on the price at which a debtor's primary residence can be sold by the secured party. Prior to March 2017, the proceeds of such an enforcement had to be at least 70% of the assessed value of the property, following the change, the proceeds must be at least 100% of the assessed value of the property within the first year and 90% of the estimated value in respect of any subsequent enforcement attempt.[3]

— **Personal bankruptcy**
A new concept of personal debt relief proceeding ("personal bankruptcy") was introduced in Hungary on 1 September 2015. The purpose of personal bankruptcy proceedings is to attempt to reach a composition agreement between debtors (natural persons) and their creditors in order to facilitate their ability to repay debts by, for example, rescheduling repayment instalments. Once such proceedings are commenced, creditors may only enforce their claims within the framework of such proceedings (i.e. enforcement of security cannot take place).

Qualifying Criteria for Personal Bankruptcy

1. **Amount of total debt:** the debtor's aggregate indebtedness (including costs, fees, interest) is between HUF 2 million (approx. EUR 6,500) and HUF 60 million (approx. EUR 195,000).
2. **Debt overdue:** aggregate indebtedness of at least HUF 500,000 (approx. EUR 1,600) has been due and unpaid for at least 90 days.
3. **Debtor acknowledges debt:** at least 80% of the indebtedness is acknowledged or not contested by the debtor.
4. **Debt/Assets Ratio:** the indebtedness exceeds the value of the total assets of the debtor but is less than 200% of the total value of the assets of the debtor.
5. **Consumer Credit:** at least part of the indebtedness relates to consumer credit (including residential mortgage loans).

The act provides for new types of personal bankruptcy proceedings:

— **Voluntary composition agreement**
If the debt includes one or more mortgage loans, the first attempt to reach a composition agreement must be made within the framework of an out-of-court personal bankruptcy. In that case, the procedure is managed by the principal creditor. If the principal creditor is the only creditor (or the other creditors are affiliates of the principal creditor), it must and in all other cases it may engage in this process. If

the principal creditor is not willing to manage the process (and has no obligation to do so), the process is deemed to be unsuccessful. A composition agreement is reached only if all creditors are party to it. If no composition agreement can be reached, the competent court orders the commencement of a judicial personal bankruptcy proceeding.

— **Judicial personal bankruptcy proceedings**
  Proceedings can be ordered by the competent court without the consent of creditors. A receiver is appointed to monitor the financial affairs of the debtor. The purpose of the judicial personal bankruptcy proceeding is to reach a composition agreement with the majority of the creditors.

— **Debt repayment proceeding**
  If no agreement is reached in the course of the judicial personal bankruptcy proceeding, the court orders a debt repayment proceeding. The receiver, with the involvement of the creditors, prepares a repayment plan setting out the rules and process for selling the debtor's assets, the allocation of the proceeds of sale and the obligations of the stakeholders. The length of the debt repayment proceeding is 5 years, and may be extended by an additional 2 years period.

If the debtor complies with the provisions of the composition agreement/debt repayment plan in all regards and all creditors' claims are recovered at the minimum rate set out under applicable law, the debtor is released from any remaining obligations. The minimum rate of recovery for a secured creditor is the market value of the property (asset) encumbered for its benefit.

Proposed changes relating to commercial loans
Proposals have also been made, with more limited success, to improve the resolution of commercial NPLs:

— **Out of court resolution**
  In 2010, the Hungarian Banking Association developed a set of non-binding principles based on the London Approach to aid out of court restructuring in the Hungarian market (the "Budapest Approach"). The Budapest Approach aimed to create principles for the restructuring of debtors facing financial difficulties, the cooperation among stakeholders during such a restructuring and the creation of a code of conduct for creditors. It contemplated, amongst other things, the preference for out-of-court restructuring, the provision of new money, the granting of a standstill period, and the conclusion of an independent business review. In practice, however, the Budapest Approach was not used by market participants for the following reasons:

  - it was often felt to be too general to be applied in practice to the practicalities of restructuring in a Hungarian context;
  - a significant number of banks did not participate in the elicitation of the Budapest Approach and did not "buy in" to the process; and
  - the application of the Budapest Approach has not been endorsed or encouraged by the Hungarian regulator and there has been little incentive for compliance.

  EBRD and MNB have been working together to develop improved out of court restructuring guidance to aid restructuring in the Hungarian market, with the intention that such new guidance would be:

  - based on the practical experience of a wider group of market participants; and
  - issued to market participants by MNB in the form of a non-binding recommendation and with more detail on the corporate restructuring process.

  We understand that the draft recommendation has now been finalized and MNB is seeking internal approval for its issuance.

  The effectiveness of out of court restructuring measures is, however, dependent on the ability to bring debtors to the table with the prospect of fair, transparent and effective insolvency proceedings if the debtor fails to co-operate.

— **Proposals for reform of the administration and insolvency regime**
  Banks have raised the following issues as being problematic in connection with the current administration and bankruptcy regimes in Hungary:

- the current Insolvency Act[4] has not been significantly updated since its issuance in 1991 and many consider it unfit for purpose in a Hungary which has acceded to the EU, faced a financial crisis and seen a growth of a new NPL market;
- they do not provide recognition or protection for new money made available in order to promote a solvent restructuring;
- the administration regime is often used primarily to delay resolution of insolvency rather than to promote a genuine attempt at solvent restructuring;
- there is a lack of transparency and creditor control over the performance by bailiffs and insolvency officers of enforcement and insolvency proceedings;
- bankruptcy proceedings may only be commenced by debtors (and not by creditors); and
- the Hungarian tax authority is unable to vote in support of solvent restructuring and many otherwise viable schemes are unable to proceed without such support.

Although there has been much discussion concerning the reform of Act XLIX of 1991 on Bankruptcy and Liquidation Proceedings, the timing and extent of such a reform is uncertain.

— **Greater transparency on insolvency sales**
On 1 January 2015, the Ministry of National Development established the Electronic Sales System ("EÉR") as an electronic platform for organizing the sale of assets being disposed of in insolvency proceedings. The aim of the EÉR is to provide a more transparent method of selling distressed assets within the insolvency process.

Creating a market for NPLs

MARK ZRT.

In November 2014, the MNB, with technical assistance from the IMF, established MARK Zrt. as an asset manager capable of acquiring NPL assets from Hungarian banks at market prices. A concern for potential sellers was that transactions conducted with MARK Zrt. (owned 100% by the MNB) may be open to challenge on the basis of state aid. In February 2016, the EU Commission provided comfort that the market pricing methodology developed by MARK Zrt. was compliant with EU state aid rules.

Between March and June 2016, a number of Hungarian commercial real estate lenders registered their interest in selling assets to MARK Zrt. and MARK Zrt. began its legal and financial review of the assets being offered. MARK Zrt. aims to offer a market price for the assets offered to it by the Hungarian banks, but the process is voluntary and the Hungarian banks are not required to dispose of the offered assets to MARK Zrt. From the banks perspective, the difficulty with the proposal is that Mark Zrt. makes an all or nothing proposal for the portfolio. Many banks have found that the flexibility of a market sale offers a better overall return than that offered by MARK Zrt.

To date, MARK Zrt. has completed only one portfolio acquisition, but the process of preparing assets for sale to MARK Zrt. has readied Hungarian financial institutions for such sales and a number of portfolio sales to outside investors took place during 2017.

MARK Zrt., along with a number of other Hungarian providers, now also offers servicing and debt management services to international investors interested in investing in Hungarian NPLs.

On 10 April 2017, MNB announced that it will sell MARK Zrt. to a Slovakian professional investor, APS Investment s.r.o. According to MNB, the volume of the NPLs has dropped by 50% and therefore there is no longer a need for the state presence in connection with the operation of MARK Zrt.

Facilitating transfers of loan receivables

Under the Hungarian Civil Code, purchasers of NPLs generally require the consent of the underlying borrowers if they wanted to acquire anything beyond a simple assignment of the client receivables (e.g. to include the contractual position as a whole together with all rights and obligations and ancillary products related thereto). This concept has contrasted with transactions involving investment services and insurance where the law has for many years allowed portfolio transfers based on the approval of the regulator.

In June 2015, the Hungarian Parliament passed a comprehensive package of legislative amendments impacting various pieces of legislation, including Act CCXXXVII on Credit Institutions and Financial Enterprises (the "Banking Act"). The package includes a broad regulatory regime for the transfer of banking portfolios alongside other provisions to address issues arising from the recent bankruptcy of a number of brokerage companies and associated scandals. The amendments entered into force on 7 July 2015 and the new transfer regime has facilitated a number of significant NPL transactions during 2016.

Broad product scope – The new regime under the Banking Act contains two sets of similar (but not identical) rules covering transfers of (i) deposits and payment services products and (ii) credit and leasing products and the purchase of receivables. For credit and leasing products and purchase of receivables, the application of the new regime requires the transfer of a portfolio of at least 20 contracts or that the receivables in question exceed HUF 10 billion (approx. EUR 31.6 million).

Capturing ancillary products and collateral – It is common banking practice that a number of ancillary products are packaged with the main product or that additional services are provided to clients e.g. to enable the client to access the product electronically. In addition, banks take various type of collateral to secure their exposure to clients. To tackle the position of such connected products and collateral, the amended Banking Act also covers the transfer of these to the purchaser as a part of the new regime, albeit with differences depending on the underlying banking product type.

Transfer based on regulatory approval – The principal position of the new regime is that the transfer is completed on the basis of approval of the MNB, the financial regulator, without requiring client consent. Clients must, however, be informed in advance of the proposed transfer (30 or 60 days' notice, depending on the product type), and are given a legal right to terminate their contract at no extra cost to them. Such termination right is intended primarily to address consumer protection issues and is unlikely to be helpful for heavily indebted clients. It must however be taken into account when structuring migration processes as between buyers and sellers of portfolios.

Tax Takeaways for Potential Investors in Hungarian NPL Portfolios

1. **Hungarian Permanent Establishment:** Foreign entities can be subject to Hungarian corporate income tax and local business tax if they have a Hungarian permanent establishment (i.e. the entity has a fixed place of business in Hungary, such as a branch office or similar presence) to which the transaction is related. The assessment of this risk requires a deep factual analysis of the investor's activity regarding the acquisition of the NPL portfolio.

2. **Hungarian Licensed Entity/Branch:** The entity purchasing the NPL portfolio can be subject to bank tax on the basis of the profit/balance sheet total increase due to the portfolio if it is a Hungarian licensed entity or a Hungarian branch of such foreign entity. The actual rate and base of the tax depends on the type of the licensed entity (i.e. whether it is a commercial bank or other financial organization).

3. **Transfer Tax Liability:** The acquisition of collateral, such as real estate or shares in a real estate holding company securing the loans, due to foreclosure or an arrangement between the debtor and the investor can be subject to transfer tax. Various transfer tax exemptions/allowances are available for institutional investors to mitigate their transfer tax liability.

4. **Hungarian Corporate Income Tax:** Capital gains from the sale of shares, acquired as collateral, in a Hungarian real estate holding company can be subject to Hungarian corporate income tax even if the investor is a foreign entity, depending on its jurisdiction of tax residence with such risk being mitigated by planning the exit in advance with carefully choosing the jurisdiction of tax residence or setting up a corporate structure in which the participation exemption provided by the Hungarian corporate income tax law can be applied.

5. **VAT Liability:** The purchase of NPL portfolios should not incur VAT liability in Hungary, however, the Hungarian Tax Authority somewhat restrictively interprets the case law of the Court of Justice of the European Union to this end. Accordingly, there can be scenarios, in particular transactions involving the purchase of other assets (such as real estate), where the risk of VAT liability may not be entirely excluded and should be reviewed.

Issues to consider for investors in Hungarian NPLs

Licensing requirements

In Hungary, the provision of financial services – including the acquisition of loan receivables – requires MNB licensing if conducted in a business-like manner. According to the applicable legislation a financial service is provided in a business-like manner if the following three criteria are met cumulatively: (i) the activity is conducted regularly; (ii) consideration is received; and (iii) the service is provided generally and not only to specified persons or in respect of specific transactions. MNB has taken a particularly strict approach to this issue, reminding Hungarian financial institutions that the acquisition of a single portfolio or the acquisition of two receivables annually can be considered to be made regularly.

Accordingly, any purchaser of NPLs, acting in a business-like manner, must be a financial undertaking or a bank[5] with a lending license (or an equivalent licensed entity regulated in another OECD jurisdiction).

MNB, in both periodical and general reviews of financial institutions, requires licensed Hungarian entities to report to the MNB on any sales of receivables that such entity may make – and requiring any purchaser of such receivables to be licensed or to make a formal declaration that it is not acting in a business-like manner. Fines ranging from approx. EUR 30,000-60,000 have been imposed throughout these investigations several times.

This has proved a disincentive for many international investors, as investments are often made through an investment vehicle and the timeframe for a receivables sale is not usually sufficient to allow a bidder to establish a financial institution prior to knowing whether its bid to acquire the receivables in question has been successful. This gives a clear commercial advantage to investors with an existing regulated presence in the Hungarian market or a partnership with a local financial institution.

Tax

The Hungarian tax environment is very investor-friendly (unless the investor is subject to a sectorial surtax, such as marketing tax or bank tax): the corporate income tax rate being 9% from 1 January 2017, among the lowest in Europe and with no withholding tax being levied on outbound interest or dividend payments.

Concluding Thoughts

Hungarian administration and insolvency proceedings are not transparent. Local knowledge in dealing with borrowers, liquidators and other market participants is key to a successful workout strategy and foreign investors often look to work with a local partner. Thorough due diligence and the development of workable enforcement and workout strategies are key to realizing value and maximizing asset returns in relation to an NPL portfolio transaction. ■

1. Source: http://npl.vienna-initiative.com/countries/hungary/.
2. According to a recent press release of MNB, the volume of non-performing loans has dropped by 50%.
3. Before the property is sold, a court bailiff must establish its appraised value, both vacant and occupied, considering the details of an up-to-date official tax and value certificate – and if so requested by either party, such appraised value can be reviewed by a forensic valuation expert.
4. Act XLIX of 1991 on bankruptcy and liquidation proceedings.
5. In Hungary, banks or financial undertakings (jointly referred to as financial institutions) may provide financial services basically. Financial undertakings may provide a limited number of financial services (e.g. they are not entitled to collect deposits, to provide payment services, to issue e-money, or to provide money exchange services) and are in turn subject to lighter regulatory requirements.

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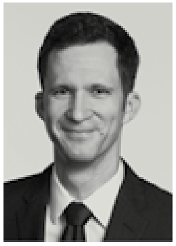

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