MORTGAGE BANKS AND MORTGAGE BONDS

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1. Introduction

Increasing interest in the Hungarian real estate market and its financing may attract additional foreign investors to Hungary in the coming years. Mortgage banks already operate in Hungary as an alternative source of financing. These banks can issue mortgage bonds, which may be of interest to those who wish to invest in securities having a long maturity and which yield low interest. The Act on Mortgage Banks, which came into effect in June 1997, sets out the legal framework for long-term real estate credits and mortgage bonds. The state currently supervises about 11 mortgage banks, which have been established since 1997.

The Act on Mortgage Banks (Act XXX of 1997) specifically regulate the operation of mortgage banks, however, other legislation is also applicable. This includes the Act on Credit Institutions and Financial Enterprises (Act CXII of 1996), the Act on the Offering of Securities, Investment Services and on the Stock Exchange (Act CXI of 1996) and Law Decree 28 of 1982 on Bonds.

2. Establishment and Functions of Mortgage Banks

A mortgage bank may only be set up and operated in the form of a company limited by shares (in Hungarian, "Rt.") or as a branch of a foreign credit institution (Section 8 (1) of the Act on Credit Institutions and Financial Enterprises). Its minimum registered capital must total HUF 3 billion.

Pursuant to Section 2(1) of the Act on Mortgage Banks, a mortgage bank is a specialized credit institution. Its most important activities are granting loans covered by mortgages on real estate and for collecting sources for lending issuing mortgage bonds, however, unlike other credit institutions, a mortgage bank may not collect deposits.
In order to increase the level of security of mortgage bonds and the creditworthiness of investments, the services which a mortgage bank can provide are limited. Only certain activities may be carried out in addition to granting mortgage loans and refinancing through the issuance of mortgage bonds (other permissible activities include hedge transactions by means of derivative financial instruments in order to avoid the risk of currency and interest fluctuation, and the safekeeping of debenture bonds (promissory notes) with respect to the bonds issued by the mortgage bank and organizing the offering of self-issued mortgage bonds). Section 4(2) of the Act on Mortgage Banks further prescribes that the amount of a mortgage loan and the obligations of the bank may not exceed 70% of the loan security value of the real estate in question.

The mortgage banks are under special state supervision, and a property supervisor monitors all mortgaged assets on a regular basis. The basic principle for appraising the value of the pledged real estate is set out by law.

3. Conditions of a Mortgage Loan

The mortgage on the respective real estate is the main element of the mortgage loan. Accordingly, the credit ability or worthiness of the borrower is judged on the basis of the real estate rather than on the basis of other financial situation of the borrower. Mortgage loan contracts concluded between the mortgage bank and the borrower must be executed through public documents, which must be authorized by a public notary. The mortgage bank may prohibit the alienation and encumbrance in order to secure its mortgage with respect to the real estate which serves as the collateral. Further, it may stipulate that the loan cannot be repaid before its maturity. This is relevant since a loan that yields interest is financed through issuing of mortgage bonds, which also yield interest. This may be necessary to secure the safe operation of the mortgage bank in the case of issue of fixed interest mortgage bonds for the following reason. Fixed interest loans may only be granted, if fixed interest bonds are issued for financing such loans. If the borrower would have an opportunity to repay the loan prior to the maturity without payment of the fixed interest for the remaining period of the original term, the mortgage bank would suffer damages due to the obligation of paying fixed interest for the mortgage bonds. This may be specifically important in the event, if reduction of interests may be anticipated, which may occur in the case of reduction of inflation rate. In this case new loans may only be granted at a lower interest rate, therefore, the mortgage bank would have no coverage for the fixed interest of earlier issued fixed interest bonds.

4. Mortgage Bonds

Mortgage bonds are bearer bonds or registered bonds which can only be issued by mortgage banks. The bonds must comply with various requirements set out in Section 11 of the Act on Mortgage Banks (e.g., the property supervisor's confirmation of available and adequate mortgaged assets). According to Section 14 of this Act, mortgage banks must always have receivables from pricipal and intrest of the granted mortgage loans available at a value which is equivalent to the total unpaid nominal value and interest relating to all mortgage bonds in circulation.

Bearer bonds may be introduced onto the Budapest Stock Exchange. In general, the issuer of a debenture bond (promissory note) must have been in operation for at least a year. However, in order to provide for the fast refinancing of granted loans, this rule does not apply to mortgage banks.

If the mortgaged real estate is sold via court execution proceedings or liquidation proceedings, the mortgage bank will have priority over other creditors except child support other support and employees wages in case of a court execution proceeding. This allows the mortgage bank to obtain sufficient assets to satisfy the claims of the bondholders.
Taxation of Interest

If the bondholder is a natural person, the income tax payable with respect to the interest is zero (Sections 65(4) of the Act on Personal Income Tax, Act CXVII of/1995). If it is a Hungarian legal entity, the corporate tax on the bond's interest is 18%.

According to Section 29 (14) of the Act on Corporate and Dividend tax, Act LXXXI. Of 1996 since 1998, a transitional rule has applied to foreign entities in connection with their investments in bonds. The interest paid on a bond issued by a Hungarian credit institution before December 31, 1997 will not be included in the tax assessment calculation of a foreign entity. In the case of those bonds for which this transitional rule does not apply the mortgage bank will deduct and pay a tax of 18% on the interest that is due to the foreign entity (Section 15(1) lit b), Section 25(1) of the Act on Corporate and Dividend Tax). If Hungary and the foreign entity's resident state have entered into a double taxation treaty, according to which the resident state is entitled to tax the interest, the interest will not be taxable in Hungary if supporting documents evidencing this, pursuent to Appendix No.5 of Act on Rules of Taxation Act CXI of 1990.

Mortgage bonds are regulated by law and provided high level of securitization, which ensures a favourable and relatively secure environment for investments.

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