FHB House Price **Index** analysis of 2010 and House Price **Prognosis for** 2011

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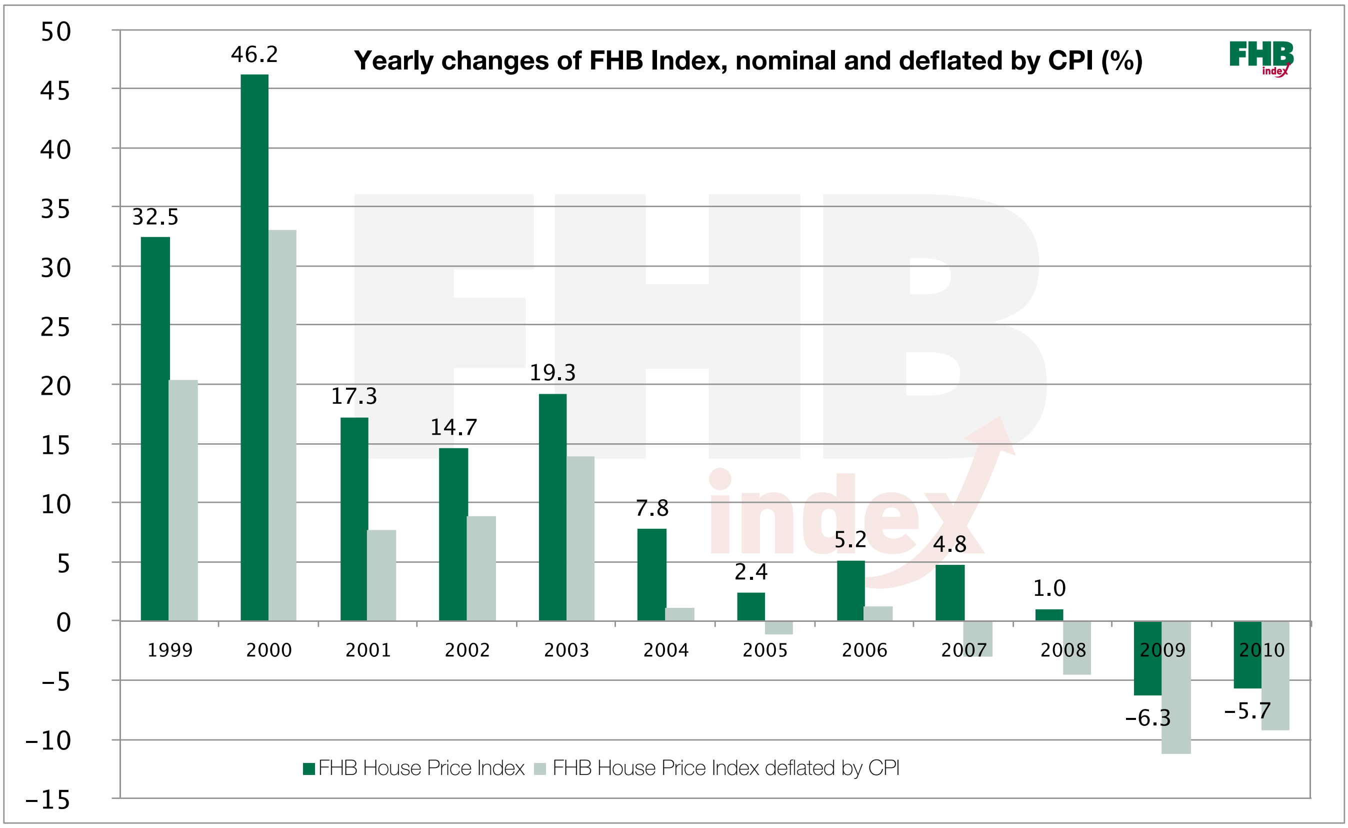
FHB House Price Index

Decline of house prices has slowed down

According to the latest data of the Hungarian housing market, **FHB House Price Index recorded an average drop of 5.7% in 2010 compared to 2009** (Chart 1) equalling 9.2% decline in real terms.

Chart 1: Yearly changes of FHB House Price Index (Source: FHB)



FHB House Price Index values in 2010:

2010q1: 177.6 **2010q2: 177.6** **2010q3: 172.9** **2010q4: 169.7**

Decline of house prices – in line with our previous forecast – has slowed down, according to FHB Index data of 2010. Most of the effects of the crisis materialized one and a half years ago, in the third quarter of 2009, therefore, in the second half of 2010 we recorded an average drop of 3.1% (6.8% in real terms) compared to the same period of the previous year. In producing the latest Index, we relied on FHB's market information and observations, as well as data processed by Stamp Duty Offices until January 2011; figures for the first half of 2010 were also revised accordingly.

(For the total time series of FHB Index see Chart 2)

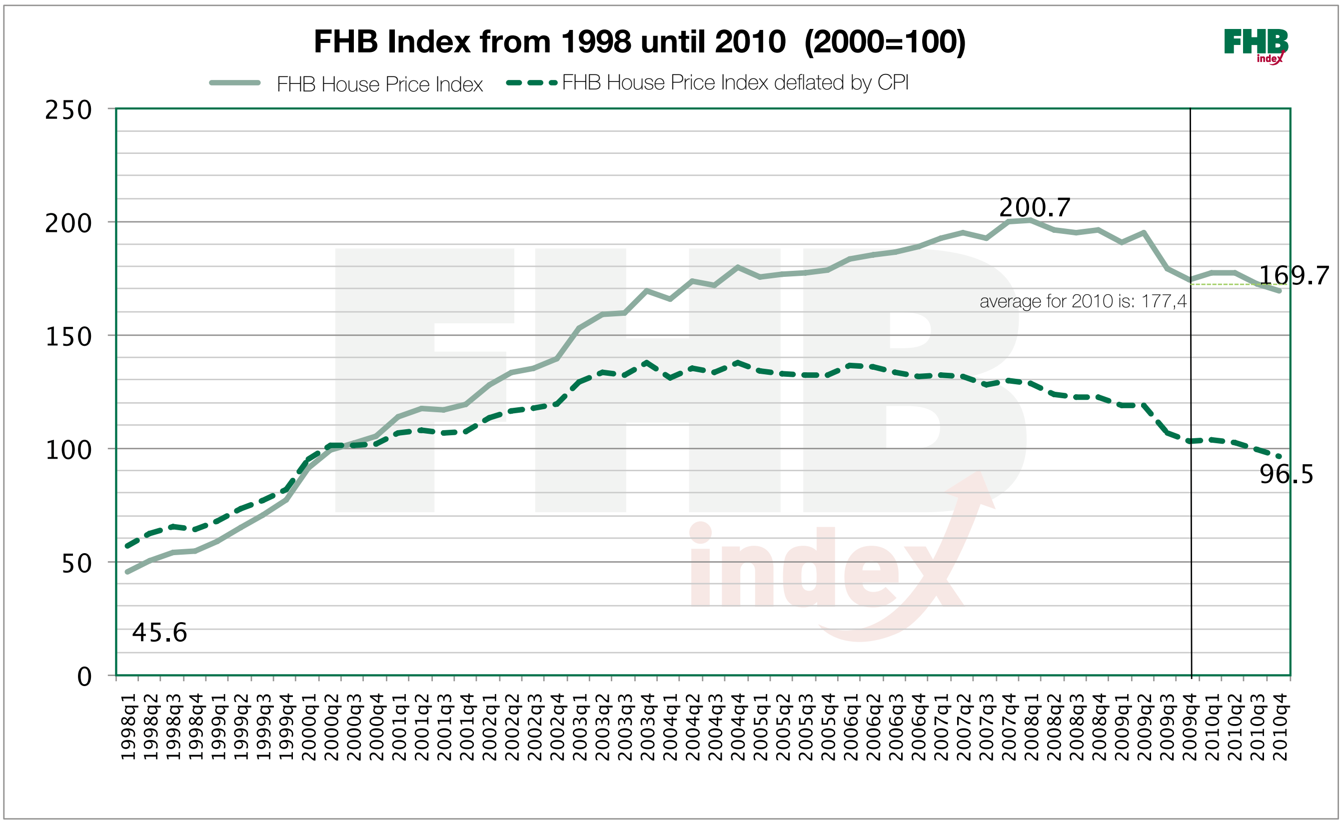


Chart 2: The FHB House Price Index (Source: FHB)

2. Analysis of 2010

Moderate decline of house prices, at some locations housing market seemed to be frozen

The first issue of FHB House Price Prognosis was published at the beginning of 2010. The prognosis – which was also updated in the summer – serves as a good basis to assess the year of 2010 compared to our previous expectations. As we expected, weak demand resulted in the reduction of house prices and turnover. **Decline of prices in 2010 measured 5.7% compared to 2009, which was slightly smaller than forecasted in FHB House Price Prognosis**: we foresaw a drop of 9.2% in February, and a drop of 7% in September. The number of transactions, however, was even lower than expected before – we estimate the turnover on the housing market in 2010 to have sunk to 72 thousand transactions (Chart 3). As we have already indicated before, the low number of transactions suggests that sellers are reluctant to lower their prices; therefore, the rate of the decline, recorded by the Index that is based on transactional data and measures only realized decline, falls behind market expectations.

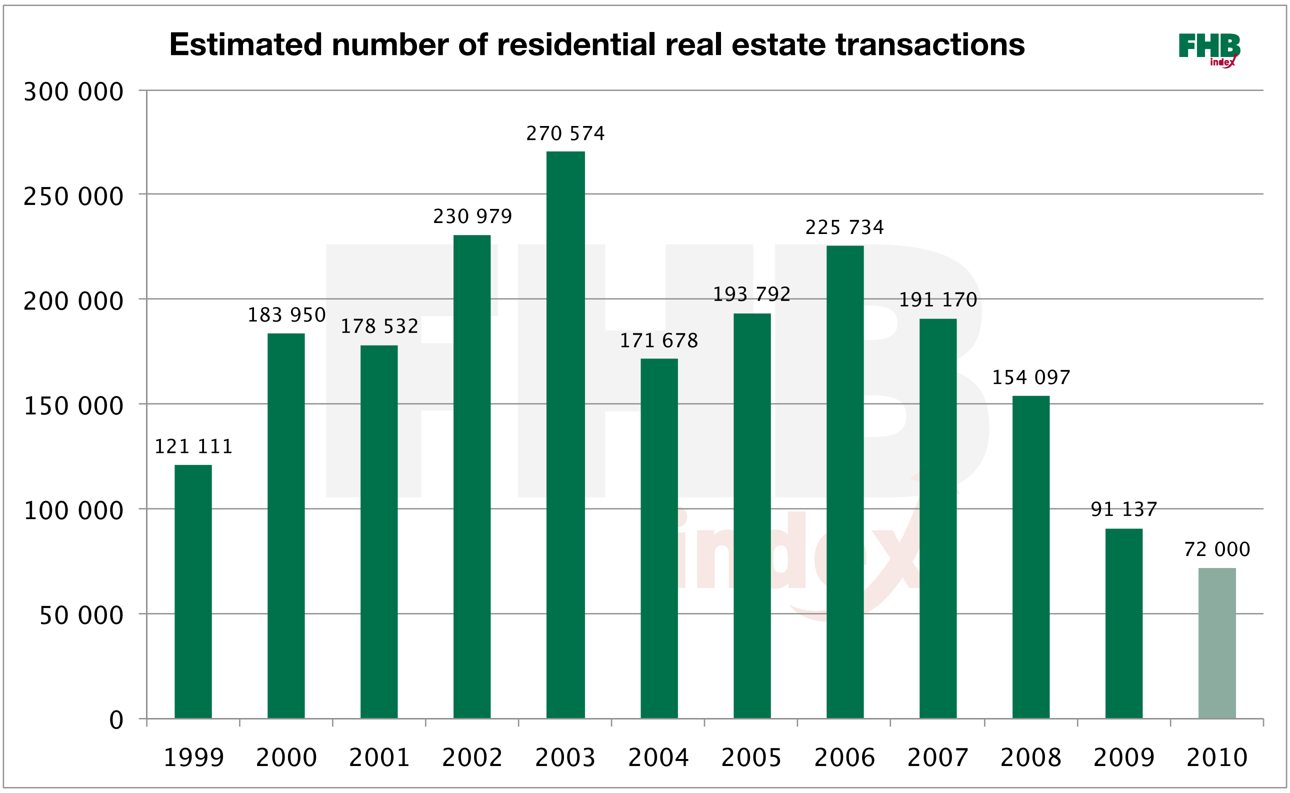


Chart 3: Turnover on the housing market (Source: KSH and FHB estimation)

If we examine the so called Set-back phase (which started at the beginning of 2008 on the housing market), **a nominal rate of 15% and a real rate of 26% drop can be recorded in the last three years**. It is thus still true that no waterfall has occurred; price effects caused by the slowdown of the housing market (both in demand and supply) attest that there was no real estate bubble in Hungary.

Change in households' income did not boost demand

Factors influencing demand on the housing market remained at a low level during the whole year of 2010, deterioration of indicators has, however, slowed down. The rise of households' income was uncertain, rate of employment was stagnating. The reduction of charges on property purchase (duty rate for the amount above 4 million HUF was lowered from 6% to 4% at the beginning of 2010) did not result in permanent upswing, some buyers only postponed their purchases planned for the end of 2009.

Permanently slack credit market

The activity on the credit market was rather feeble in 2010, lending declined. As a result of repayments, households' net debt position has improved significantly. Volume of new contracts barely reached one fifth of the pre-crisis level. Changes in regulations caused the moderate demand to turn toward Forint loans (Chart 4). Average percentage rates of new HUF loans (calculated at the time when it was granted, including also discounts for the first interest periods) are more favourable partly because lenders are offering products with lower initial interest rates. **Until it is forbidden to secure FX denominated loans by a mortgage, relative interest advantage of Euro loans cannot manifest.**

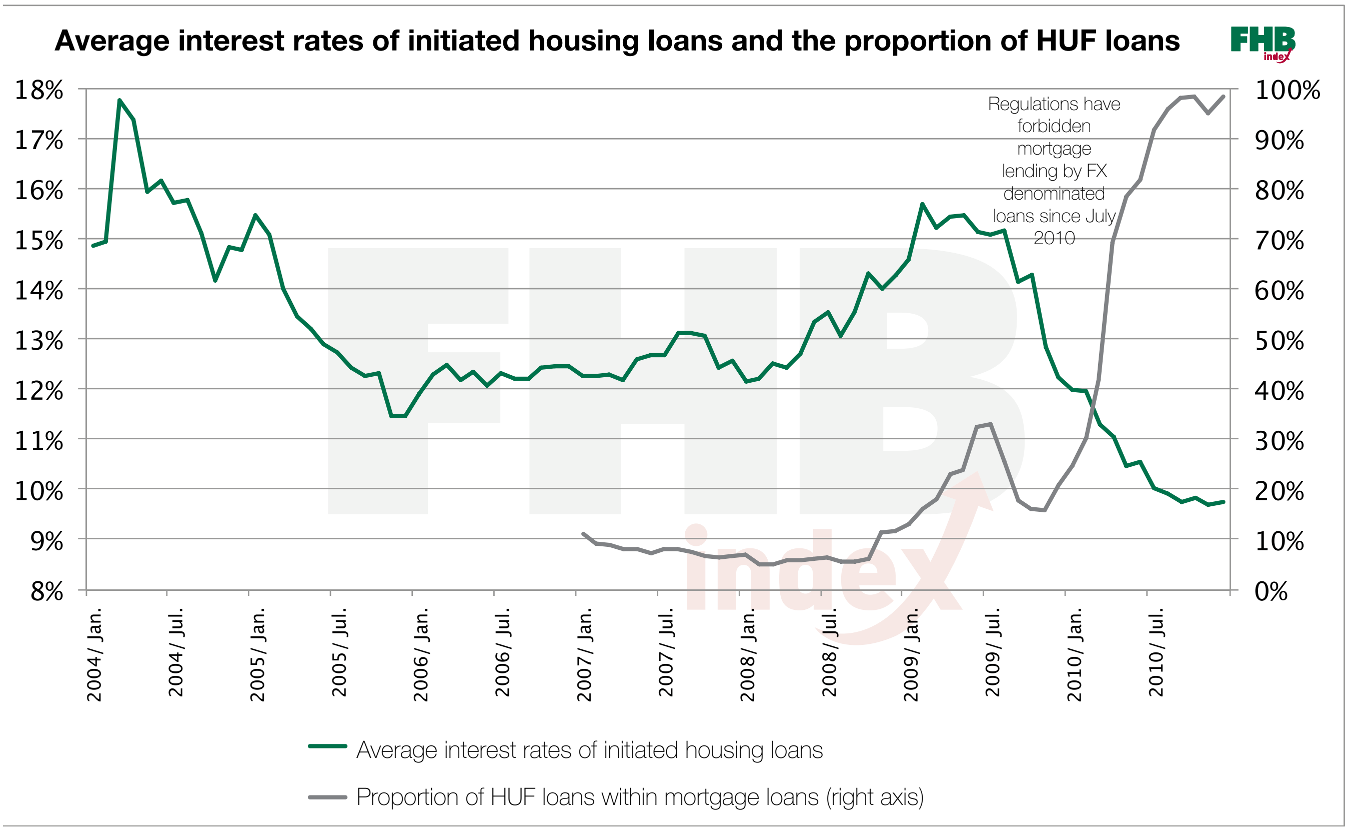


Chart 4: Characteristics of initiated housing loans (Source: MNB)

Although households are paying back significant amounts of their debts and there are also early repayments beside growing defaults, **the stock of loans in Forint is not decreasing due to the strengthening of the Swiss Franc (Chart 5).**

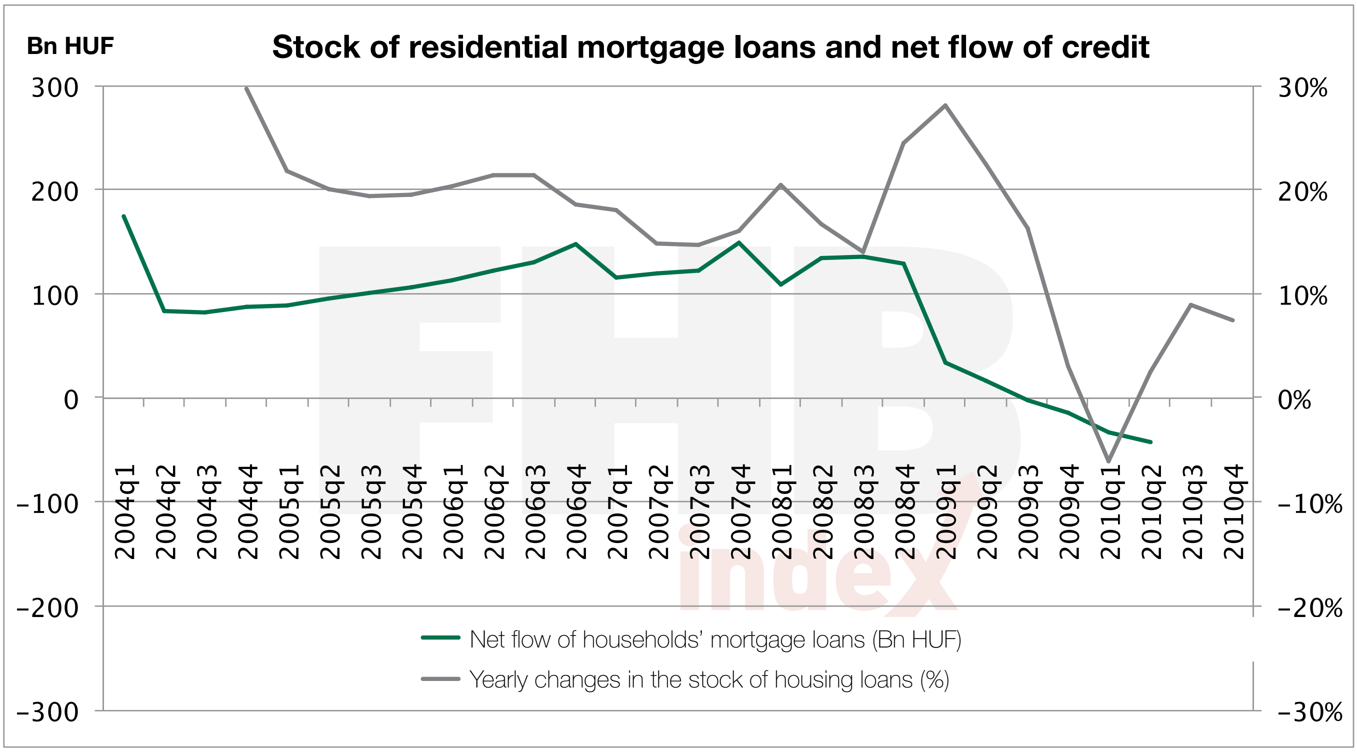


Chart 5: Stock of residential mortgage loans and net flow of credit (Source: MNB).

Melting supply

In 2010, supply has started to shrink, both of new and second-hand housing units. Developers having undergone difficult times due to weak financing and low demand have reduced the number of their projects significantly. In line with our previous expectations, construction has dropped considerably and **estimated number of new housing units in 2010 barely reached half of the 35 000 units that had been recorded before the crisis** (Chart 6). According to market researches, newly built housing units with the most favourable attributes have already been absorbed by the market. The market of second hand dwellings is still determined by **the prohibition of foreclosures,** holding back supply.

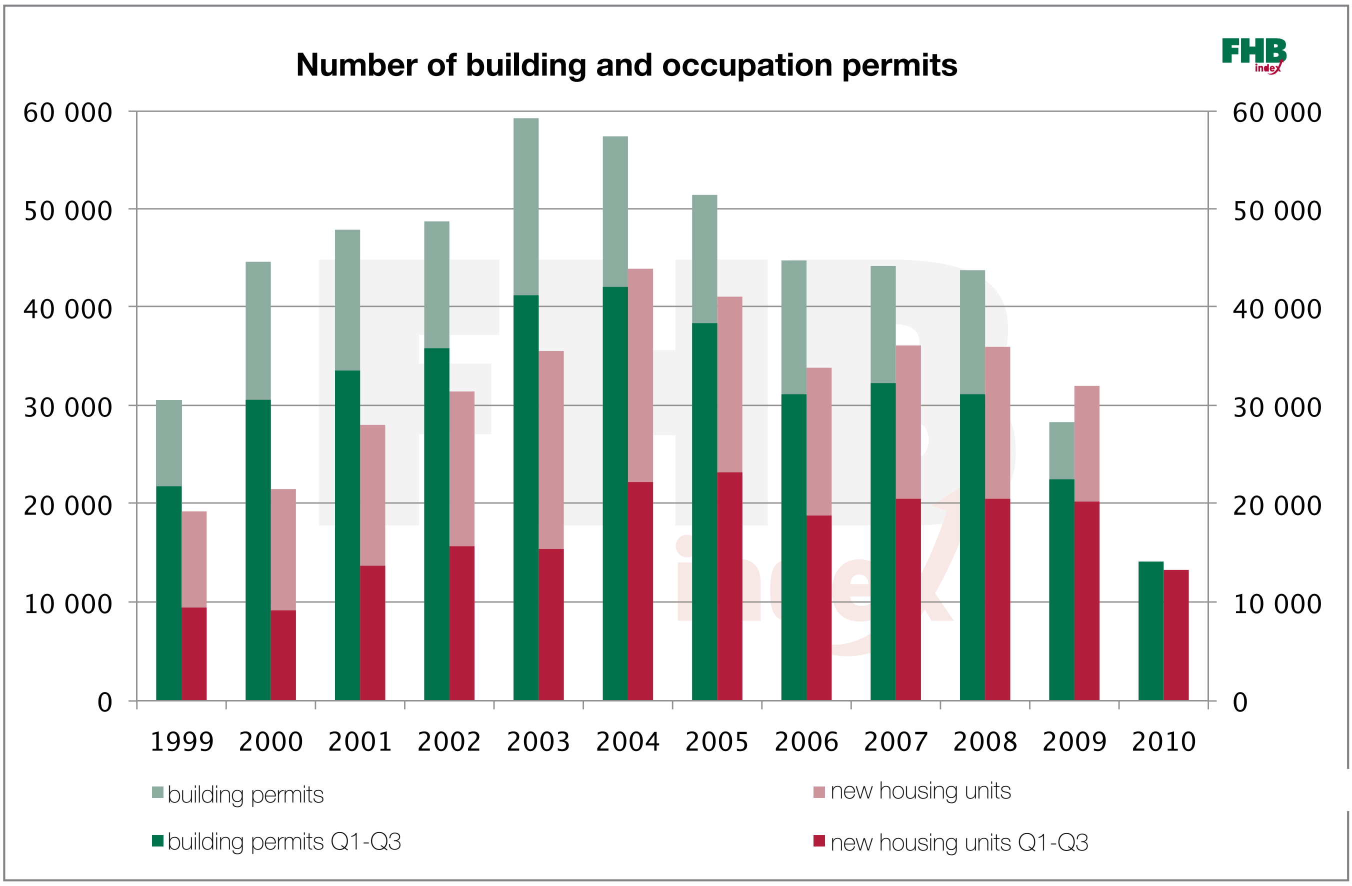


Chart 6: Building and occupation permits in Hungary (Source: KSH)

In 2010, production in the construction sector was declining by the same rate as it had been since 2009. Volume of new orders does not envisage optimistic outlooks either. Chart 7 shows the performance of the whole construction sector. The downturn of production in housing and related construction was even bigger. Surveys have shown that bankruptcy ratio of companies engaged in construction continued to rise in 2010.

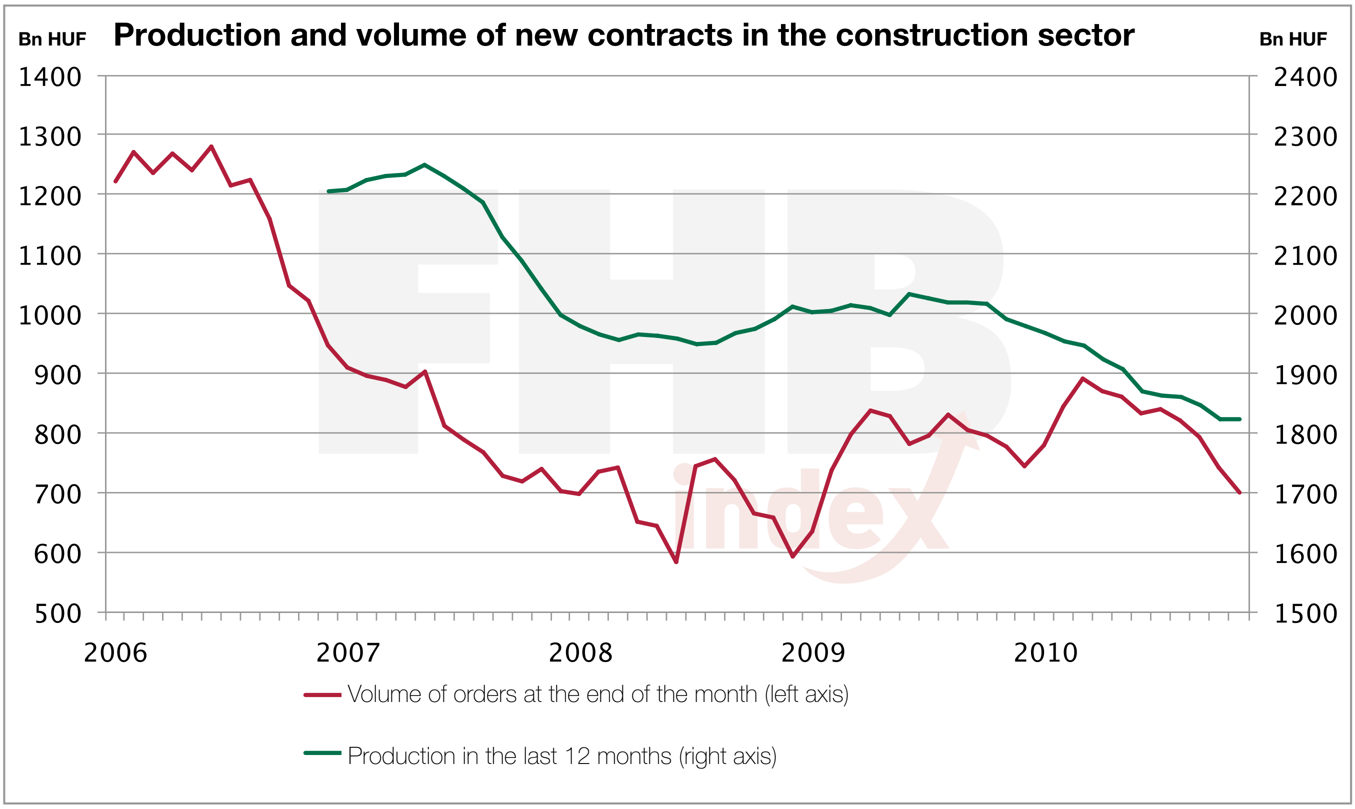


Chart 7: Production and volume of new contracts in the construction sector (Source: KSH)

3. FHB House Price Prognosis

In 2011, demand may increase moderately, supply will depend on regulatory decisions

In 2011, we expect the demand on the housing market to increase moderately. Recovery after the crisis will also be felt in households' incomes. Hungarian National Bank estimates approx. 3% growth of GDP in 2011 (Chart 8).

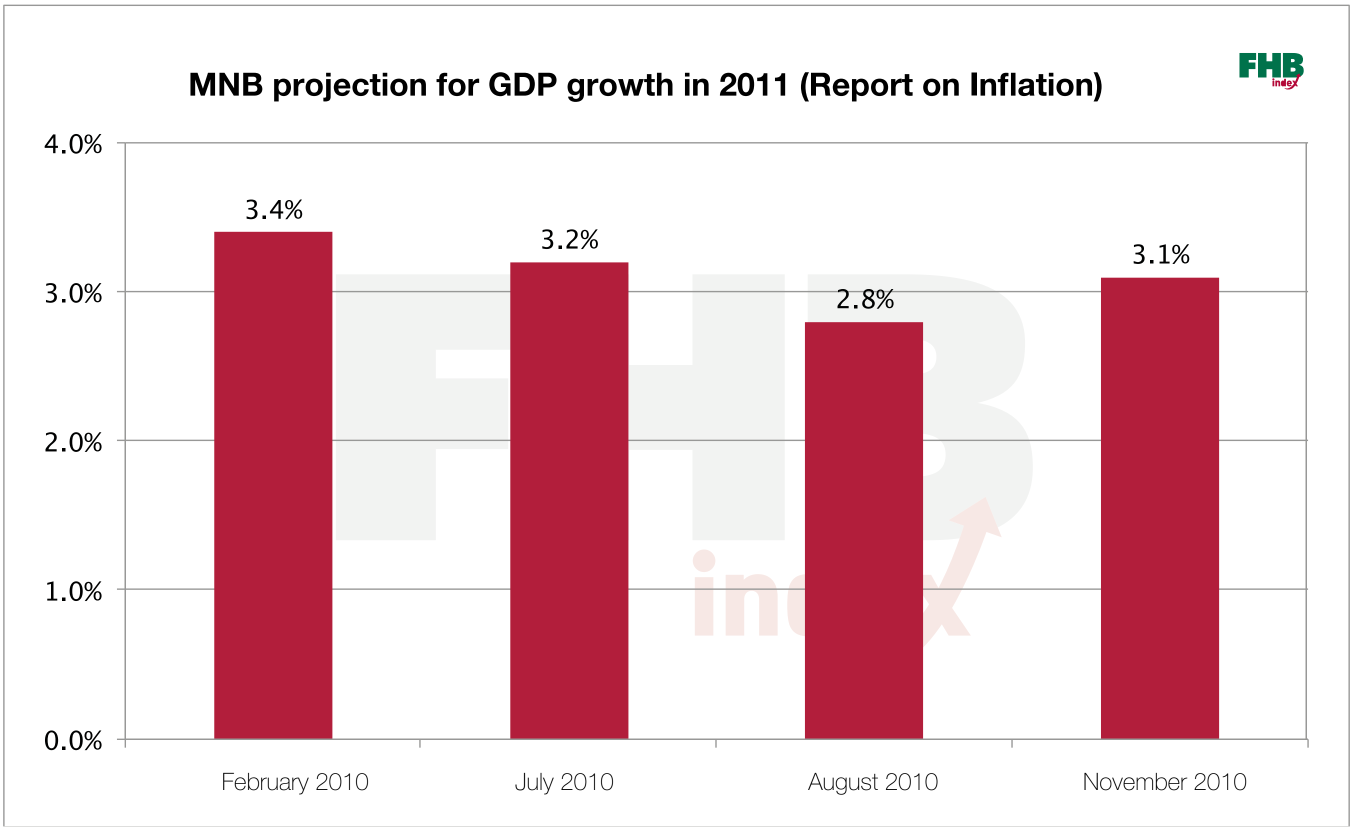


Chart 8: Projections of the Hungarian National Bank for economic growth (Source: National Bank of Hungary Inflation Report)

Real disposable income will be greatly affected by growing employment and wages but also by the changes in taxation. Reduction of personal income tax rates leaves several billion Forints surplus in households' pockets.

Stabilising economy and growing real disposable income can boost demand among families considering buying a new property, including families who postponed their moving because of the uncertain conditions during the crisis. The effect of lower tax rates on demand is, however, weakened by the fact that changes affect each income group of the population differently: extra money from personal income tax reduction remains primarily at the wealthiest tenth of the population (Chart 9). These families are already more satisfied with their dwellings than the average, therefore, it is uncertain if the changes in personal income tax really stimulate demand. At the same time, if we examine the history of the Hungarian housing market and the behaviour of Hungarian households, it also needs to be taken into account that most of the surplus – even if interest rates are high – **generates strong investors demand** on the housing market (i.e. purchases not for housing purposes), which is also strengthened by the fact that the decline of house prices is expected to come to a halt. Meanwhile, there is always demand for buying property due to changes in the family's life (first home, birth of a child, etc.), which can **also be strengthened by improving outlooks and real disposable incomes raised by child benefits, as well as attractive house prices.**

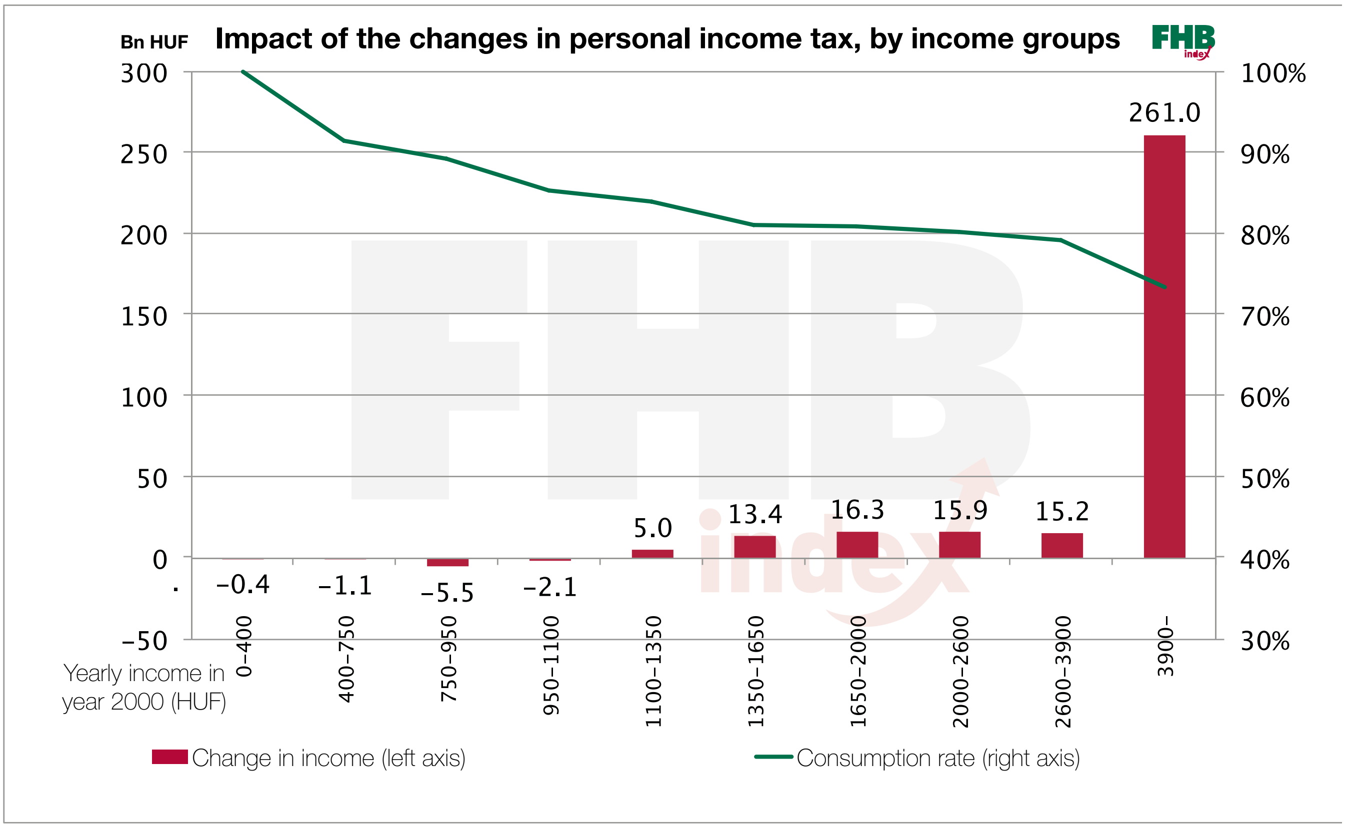


Chart 9: Effects of personal income tax changes on income
(Source: MNB Report on Inflation, December 2010)

No great upturn is expected on the credit market

The Hungarian credit market is still determined by the evolution of the exchange rate of the Swiss Franc that highly influences the debt burden on Hungarian households. Hungarian National Bank has started to increase interest rates, thus increasing costs of Forint loans can be expected. The demand for loans depends on people's confidence in lasting growth of income. **If economic growth and the consolidation of the labour market are deemed to be enduring, willingness to take loans may increase. An important factor shall be the announcement and introduction of the facilities of Széchenyi Plan regarding the government's housing policy**. Governmental measures already made public include encouraging savings at building societies (subsidized savings period has been extended and loans are available at an earlier stage) enhancing their importance, but compared to the volume of the market it will not bring a comprehensive turn.

Supply of new housing units will reach the bottom

According to the correlation between the number of building and occupation permits, **it is very likely that in 2011 the number of new housing units will fall to an even lower level than in 2010. Nevertheless we believe that the number of building permits will start to rise from the second half of 2011**. Smaller regional differences can be observed on the market: volume of developments in the capital might have left the bottom already (Chart 10) and developers might already get started for the upturn, yet construction in other parts of the country might reach the turning-point in 2011.

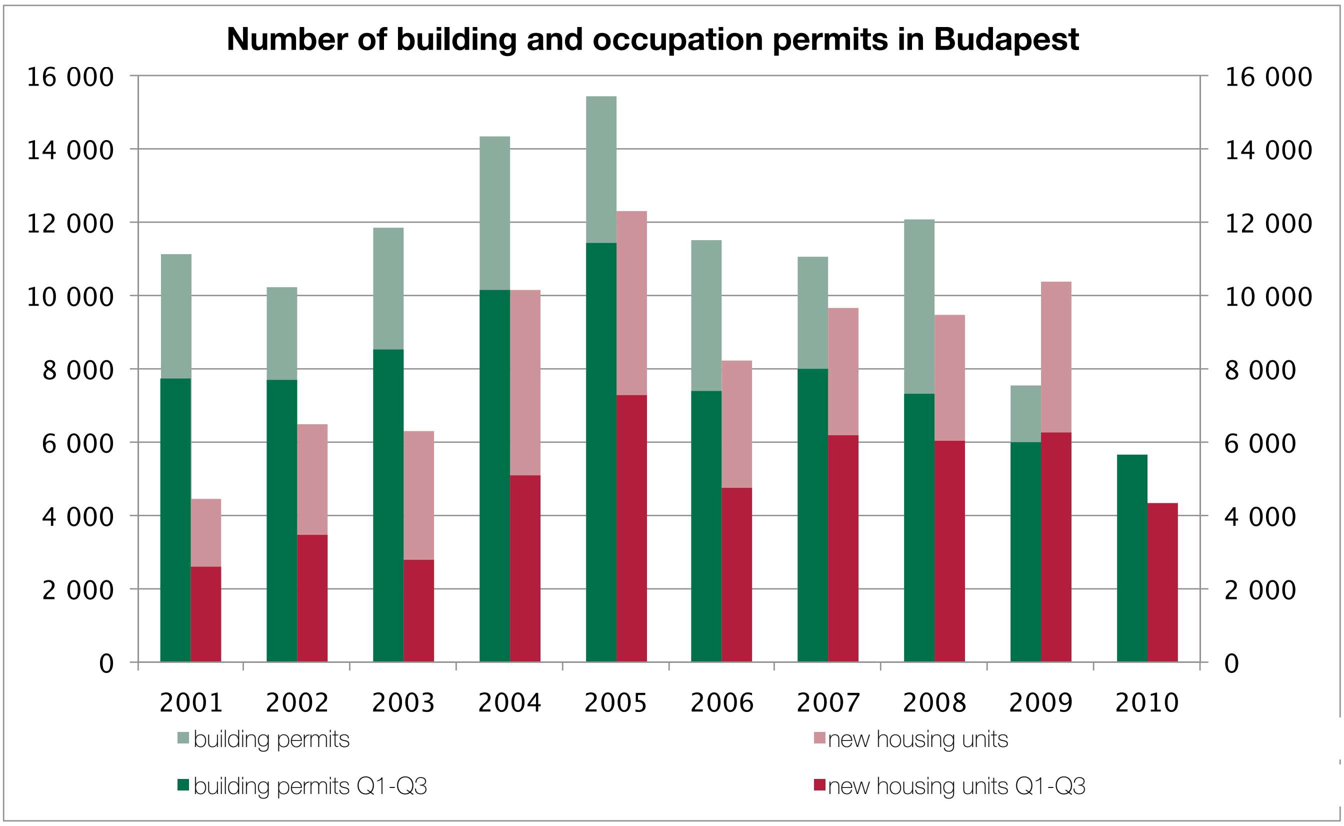


Chart 10: Number of building and occupation permits in Budapest (Source: KSH)

Shrinking supply may break price decrease, but turnover will not catch up

As a result of moderately increasing demand and shrinking supply, **we prognosticate house prices in 2011 to increase moderately, by 2% compared to 2010.** Taking inflation projections into account, this means that on a year-on-year basis average house prices would stagnate in real terms compared to the second half of 2010. Turnover on the housing market is expected to move upwards from the 2010 level – that was the lowest recorded in the last decade –, although it is yet not expected to rise up to the pre-crisis level due to weak demand and supply.

Ending prohibition of foreclosures might draw an alternative scenario on the housing market

According to PSZÁF (Hungarian Financial Supervisory Authority), there were already around 100 thousand debtors over 90 days delinquent in the middle of 2010. Original plan of the Hungarian government would end the prohibition of foreclosures in April this year. If the prohibition is not extended, debtors' properties under mortgage will appear on the market.
Due to the above possibility, we have also formed a pessimistic scenario for 2011 relying on our own data and on market participants who shared their opinions with us. Although the number of problematic loans exceeds the volume of yearly housing market turnover, we only expect properties located in "living", big cities to influence national price changes. Territorial distribution of houses potentially sold may show great differences, and the whole picture is even more distinctive if we also take local turnover rates into account (see Table 1).

Even if we presume that the number of properties – having been withheld by the moratorium before – now forced to sale will reach 50 thousand nationally, the number of properties appearing on the market of Budapest due to default will not exceed the rate of decrease in the number of new housing units since the crisis. **Therefore, the housing market of Budapest will not undergo considerable negative corrections even if these transactions take place.** Forced sales and the current slack market in some towns in the countryside, especially in smaller settlements may, however, cause price depression, but because demand constraints are quite strong, we do not esteem mass selling of properties under mortgage very likely.

Illiquid market at some locations will require efficient actions from the government or local authorities in managing properties of defaulting debtors.

	Potential forced sales as percentage of average yearly turnover
Budapest	6-15%
10 biggest cities in the country	15-20%
50 biggest towns in the country	20-30%
The other 3102 settlements	100%?

Table 1: Potential forced sales as percentage of average yearly turnover (Source: FHB calculation)

Dear Reader,

Allow us to introduce you the services FHB Index offers.

FHB House Price Index is published quarterly. Before its introduction, no other product of this kind was available in the Hungarian market – being distinctive in terms of the measured time intervals and the quality of the underlying data, as well as its methodological foundations conforming to international expectations. Since the introduction of FHB Index in 2009, MNB (Hungarian National Bank) and RICS (The Royal Institute of Chartered Surveyors) have been referring to it as a featured housing market indicator.

Updates for **FHB** House Price Prognosis are published regularly.
The methodology behind the model lies on three pillars:

I. On the basis of international and local experience, we have identified relations between selected Hungarian macroeconomic indicators, money-market and credit market indices, transactional data of the housing market and housing prices. (We base our view of the development of the macroeconomic and financial environment primarily on the projections of the Hungarian National Bank.)

II. **FHB** Banking Group has been one of the major actors of Hungarian housing market financiers for over a decade. Our operations cover the entire country, and we have access to information from the most significant real estate appraisers, which is complemented by **FHB** Real Estate Ltd's own professional experience. Our forecasts, therefore, include processed and verified local assessments as well.

III. With respect to the economic crisis, we shall not disregard empirical facts gained from analyses of similar depressions that have affected real estate prices so far. We have, therefore, included the international experience obtained from similar crises in our model.

FHB House Price Prognosis is now an important reference tool for people interested in the Hungarian housing market.

Our database covering the entire country and the methodological development of **FHB** Index make **FHB** able to provide help to the financial sector to fulfil the collateral re-valuation obligations under Basel II (Government Decree No 196/2007 on the Management of Credit Risk and the Calculation of Credit Risk Capital Requirement). We are proud that our service has already been ordered by a number of Hungarian banks, subsidies of big international financial institutions. The banks will need to comply with the strict regulations in the future too, it is, therefore, useful to apply the procedure that conforms to international standards and can also be supported by documented methodology if required by authorities. For the implementation of the modern, internal valuation methodology, it is preferable to use a model that is based on transactional data and documented methodology whereby efficient and mass re-valuation becomes possible. By using this model, credit risk capital requirement can be reduced substantially, excess capital can thus be freed.

FHB also undertakes the preparation of unique research products on individual needs. In these, we offer local information on apartments and lots, more detailed explanation for the extent and dynamics of our prognosis, and the analysis of the risks surrounding the realization of the trends forecasted.

The next issue of **FHB** Index is scheduled for May 2011. Meanwhile we are pleased to give customized offers or to respond to any inquiries

Sincerely,

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