

**ELIGIBILITY CRITERIA AND MINIMUM
REQUIREMENTS FOR REAL (*IN REM*) SECURITY
ON REAL PROPERTY IN THE LIGHT OF BASEL II
CRITERIA**

The present publication is intended to be the continuation of the publication entitled “*Impacts of the Basel II regime on the operations of financial institutions with regard to the eligibility of collaterals*” (Publication I.).

Hereby we endeavour to describe certain aspects of the eligibility and minimum requirements for real security collaterals on real property under the Basel II regime. Real estate collaterals when found to be eligible by the banks are frequently used to (i) mitigate the exposure value considered for the calculation of their capital requirement, and thereby (ii) to reduce the capital requirement. Borrowers being aware of such banking requirements and procedures can size up easier their possibilities and have a better understanding about the eligibility criteria regarding their collaterals offered to banks, which fundamentals can be advantageous for the borrower during the negotiations with the lenders.

The eligibility and minimum criteria are regulated by the Government Decree 196/2007 on the Management and Capital Requirement of Credit Risk (Government Decree) implementing the respective provisions of the CRD Directives (the Capital Requirements Directives (CRD) i.e. EC Directive 2006/48 on *relating to the taking up and pursuit of the business of credit institutions* and EC Directive 2006/49 called *capital adequacy directive*). In addition to the CRD Directives, the Government Decree and several other Hungarian statutory provisions related to the eligibility and minimum requirements and cited below, we have made references and consistently relied on the Validation Guidelines of the Hungarian Financial Services Authority’s (*Pénzügyi Szervezetek Állami Felügyelete*) (HFSA) on the implementation, assessment and approval of IRB.

Funded and unfunded credit protection

The Act CXII of 1996 on Credit Institutions and Financial Enterprises (Hpt.) and the Government Decree differentiate between two types of credit protections: funded and unfunded credit protections which concepts have been discussed in detail in Publication I. Funded credit protection is a type of risk mitigation that allows the bank to (i) acquire the underlying asset or (ii) to seek satisfaction from the proceeds from its sale in case of a risk event (e.g. event of default, liquidation procedure). Real (*in rem*) security as collateral on real estate, including real estate mortgage shall be considered as ‘funded credit protection’ provided that certain criteria specified below is fulfilled.

General eligibility requirements for exposure mitigation

If funded credit protection is eligible and the legal requirements have been met, such credit protection may be used to reduce the exposure amount underlying the capital requirement calculation. The collateral agreements (e.g. agreement on real estate mortgage) for credit protection used to reduce the exposure amount underlying the capital requirement calculation

must be (i) legally valid and (ii) enforceable in a court of law. The concepts of legal validity/enforceability can be collectively referred to as **legal certainty**, meaning that the contract for credit protection complies with statutory regulations, is valid in every element and is enforceable in a judicial process.

Legal Opinion

Banks attach a legal opinion issued by a legal department sufficiently independent of other entities within the bank or by a third party lawyer or law firm, confirming that the credit protection proposed for use by the credit institution to mitigate credit risk complies with the requirements set out in the CRD and the Government Decree. The legal opinion must address among others how eligibility and minimum criteria specified for funded credit protection are met (e.g. whether the mortgage is in compliance with the requirements set out in points a)-f) in Section 1 of Article 115 of the Government Decree). The compliance of collaterals with the CRD criteria is material for financial institutions using the Internal Rating Based (IRB) approaches as only these collaterals can be used to mitigate the exposure value considered for the calculation of the capital requirement, and thereby to reduce the capital requirement.

Eligibility and Minimum Requirements for Real Security on Real Property in accordance with the HFSA guidelines

Eligibility criteria:

- i. Both residential real estate (in which the obligor resides, will reside, or which the obligor lets or will let) and commercial real estate are eligible. The definition of residential property was established by Paragraph (4) of Article 147 of Act LIII of 1994 on Judicial Execution (hereinafter: residential property), according to the HFSA an occupation permit in itself is not sufficient for such qualification.
- ii. The value of the property as a collateral and the credit rating of the client shall be independent of each other.
- iii. The counterparty risk does not depend substantially on the capacity of the underlying property or project (cash flow generated by the collateral). The legislator defined “substantially” as 80 per cent, i.e., the repayment of the obligation should be dependent to at least 80 per cent on revenue not related to the real property.

Minimum Requirements for Real Property

The legal Certainty

- i. The contract must contain all provisions that allow the enforceability of the collateral and

its realisation within a reasonable timeframe according to the Government Decree in the applicable jurisdiction under the applicable law;

- ii. The requirement of the appropriate and timely registration of mortgages in the land registry;
- iii. The agreement must reflect an effective mortgage (compliance with substantial and formal legal requirements).

Regular Valuation of the Collateral

- iv. Under the IRB approach, the value of real property must be appraised by an independent appraiser of real property. The value may not exceed the market value. In case of mortgage credit institutions a separate Decree established the methods of calculation of the lending values of the collaterals (*hitelbiztosítéki érték*).
- v. The value of real estate must be examined at least once a year in the case of commercial property and at least once every three years in the case of residential property. More frequent reviews are necessary only upon substantial market changes
- vi. Statistical methods may be used for the review of the value of real estate and to specify which real estate properties should be revalued (according to HFSA's communication the use of the statistical method is not expected to be feasible in Hungary for commercial real estate, because the conditions for numerosity and comparability, as required for the statistical method, cannot be fulfilled).
- vii. If there is information available to indicate that the value of the real property may decline significantly as compared to the general market price, and in the case of loans exceeding EUR 3,000,000 or 5 per cent of the credit institution's solvency margin, the property review mentioned in the previous paragraph must be performed by an independent real estate appraiser. An "independent real estate appraiser" is a person who has the qualifications, skills and experience necessary for performing an appraisal, and who is independent of the process related to the lending decision.
- viii. The minimum requirement concerning insurance is to require continuous insurance coverage during the term of the exposure (e.g. loan), or any potential alternative arrangements for this (e.g., assumption of premium payment or lump-sum up front payment).

Essential provisions in the Hungarian legislation governing mortgage on real estate with regard to (i) the fulfilment of the legal certainty criteria and (ii) the enforcement criteria

Under Hungarian law, real estate may be subject to collateral in the form of

- a mortgage (*jelzálogjog*),
- frame mortgage (*keretbiztosítéki jelzálogjog*) or

- independent lien (*önálló zálogjog*)

Proper and timely recording of the mortgage

Pursuant to the Government Decree mortgage should be proper and timely recorded (under the CRD the contract must ensure a 'perfected' lien, i.e., all legal requirements for establishing the mortgage must be fulfilled). In the interpretation of the HFSA, the mortgage established on the real property is not an eligible instrument for credit risk mitigation as long as the title is recorded only as a side note on the title deed, until the registration financial institutions are not allowed to include the mortgage collateral for the calculation of their solvency capital (nevertheless it shall be noted that this failure does not prevent the granting of the loan and the acceptance of the property as collateral).

Fulfilment of the 'legal certainty criteria'

The formal and substantial requirements set out in Hungarian law on real estate registration must be met. The agreement must be concluded in the form and with the content that will enable its registration in the land registry.

Potential risks in the course of an enforcement of the collateral upon foreclosure

The position of the mortgagee of the real estate mortgage within a potential judicial enforcement procedure (*végrehajtási eljárás*) may also affect the requirement of **legal certainty**, among others:

- i. Judicial enforcement (foreclosure) by third parties is not withheld by the existence of a mortgage right on the property, nevertheless upon the registration of foreclosure rights, the mortgagee shall be notified pursuant to Paragraph (2) of Article 138 of the Act LIII. of 1994 on Judicial Enforcement, thus the mortgagee may also participate in the judicial enforcement (*bekepcsolódás*).
- ii. The mortgagee may join the proceedings only if the legal basis and the amount of the claim are not disputed by the obligor or the person requesting the judicial enforcement. If, however, the legal basis or the amount is disputed, the mortgagee may only enforce his claim arising from the mortgage in court proceeding. This problem resolved by the rule set out in Paragraph (4) of Article 114/A of the Judicial Enforcement Act, whereby neither the legal basis nor the amount may be disputed if they have been recorded in a notarial deed (*közokiratba foglalás*).

Direct enforceability criteria:

The requirement of direct enforceability is met, if the institution concludes a mortgage agreement with the client according to which upon the entry into force of the right of foreclosure (*kielégítési*

jog megnyílt) the mortgagee or the mortgagee in conjunction with the obligor has the right to sell the pledged property (the agreement for joint sale has a deadline).

Ranking of the mortgage

Financial institutions must procure to secure a first ranking mortgage. If the mortgage is not a first ranking mortgage, the real estate can be taken into account for the reduction of the capital requirement only if the value of the property had been encumbered by the preceding mortgages to an extent not exceeding the level determined in the regulations of the credit institution. If the owner intends to encumber the real property within a year, such intention shall be registered by side note (Paragraph (4) of Article 262 of the Civil Code - preliminary disposal of ranking (*ranghely előzetes biztosítása*)). In order to secure a first priority mortgage, preliminary disposal of ranking is often requested by the banks.

Prohibition on alienation and encumbrance (*elidegenítési és terhelési tilalom*)

In Hungary financial institutions usually request the land registry to register a prohibition of alienation and encumbrance. According to the interpretation given by the HFSA regarding Paragraph (2) of Article 114 of the Civil Code, the credit institution can only stipulate the above, if the purpose of the loan connected is the financing of the transfer of ownership rights to the real estate property. However, in case of mortgage credit institutions, the registration of the prohibition of alienation and encumbrance is mandatory to be verified.

Liquidation procedure

Under Hungarian insolvency law, the legal enforceability of a collateral in a liquidation procedure depends on its acknowledgement by the liquidator (creditors have 40 days from the court ruling on liquidation becoming final to raise their claims). Monitoring of potential liquidation procedures with regard to the 40 days deadline is essential. If the lien was created before the commencement of liquidation, the liquidator may only deduct from the proceeds of the sale of the pledged property the following amounts: (i) the costs of its safekeeping including the preservation of its condition - and (ii) the costs of its sale, as well as (iii) 5 per cent of the net purchase price of the pledged property for the liquidator's fees. Any remaining amounts must be served to satisfy the claims secured by the pledge.

Bibliography and references

*Government Decree 196/2007 on the Management and Capital Requirement of Credit Risk
(Government Decree)*

EC Directive 2006/48 on relating to the taking up and pursuit of the business of credit institutions

EC Directive 2006/49 (called capital adequacy directive)

*Validation Guidelines of the Hungarian Financial Services Authority's (HFSA) on the
implementation, assessment and approval of IRB.*