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The situation of real estate funds in Hungary

This study[1] is devoted to real estate funds, i.e. the major participants on the market of investment funds, which in the past years have become an area managing nearly HUF 500 billion. True, rapid boom was followed by a similarly rapid bust in this sector, where the value of savings dropped to half, i.e. to HUF 252 billion in November 2009. After presenting the impacts and factors of the financial crisis I will analyse in detail the disputed step taken by the Hungarian Financial Authority (HFSA) in November 2008 (suspension of real estate funds and the funds run by real estate funds), as well as the consequences of this move. During the analysis I am trying to find out what decisions real estate funds and legislators made in order to avoid the even more serious consequences. Finally, I will write about proposed operational and legislative changes to be considered on the basis of experience.

THE "BIG QUESTION" OF REAL ESTATE FUNDS

The enforcement of Act LXIII of 1991 on investment funds (hereinafter Investment Funds Act) made it possible for the funds to gather the savings of (small) investors and create diversified portfolios that individual investors would have not been able to do. Through the investment funds investors could reap the benefits of properties into which they could not have invested by themselves. On the other side, this allowed property owners to use resources that were less expensive than bank loans or bonds.

The above written information can be found in any textbook on investments, as the summary of the advantages and opportunities implied in real estate funds. Therefore, we have all right to ask *"what went wrong then"*, what happened and why, when not too long ago real estate funds suffered a very significant asset withdrawal/loss of over 50 per cent compared to the peak as shown in *Table 1.*

However, the real estate portfolio valued at hundreds of billions of forints is still, almost unchanged, in the ownership of the real estate funds – at least according to the data available at the closure of this paper (November 2009). The Erste Real Estate Fund is the only real estate fund where a loss of assets due to the sale of real property could be observed. Of course, the level of real estate exposure also shows that the portfolio of quickly mobilisable assets of the real estate funds has significantly dropped: in many cases payments can and could be financed from loans only. So what happened

Table 1

THE SITUATION, YIELDS AND SIZE OF REAL ESTATE FUNDS IN JUNE 2009

	Three-month yield	Yearly yield	Capital June 2009	Change in capital in 3 months	Change in capital in 12 months	Capital June 2008	Change in capital	Change in assets (%)
	%	%	billion HUF	billion HUF	billion HUF	billion HUF	%	(+growth/-loss)
Nap Real Estate Developer	20.5	14.8	1.42	0.24	0.18	1.24	114.52	14.52
Európa Property Fund A	**11.1**	**–27.08**	**16.94**	**1.67**	**–19.64**	**36.58**	**46.31**	**–53.69**
Credit Suisse Real Estate Fund	–	7.6	6.23	–1.52	–5.17	11.4	54.65	–45.35
Carion Real Estate Fund	3.1	–19.9	8.38	0.26	–1.71	10.09	83.05	–16.95
Credit Suisse Euro Real Estate Fund I	–	3.7	0.19	–3.6	0.18	0.01	1 900.00	1,800.00
Erste Real Estate Fund	**2.4**	**9**	**82.14**	**–5.51**	**–61.23**	**143.37**	**57.29**	**–42.71**
Credit Suisse Euro Real Estate Fund B	–	3.4	1.32	–0.5	1.31	0.01	1, 200.00	13,100.00
Magyar Posta Real Estate Fund	2.3	7.9	19.63	–0.89	–8.79	28.42	69.07	–30.93
OTP Real Estate Fund	**2**	**–10.6**	**35.83**	**–15.34**	**–101.44**	**137.27**	**26.10**	**–73.90**
Budapest Real Estate Fund	2	–12.5	6.23	–6.07	–24.84	31.07	20.05	–79.95
MKB Real Estate Fund	0.8	–14.4	0.9	0.01	–0.54	1.44	62.50	–37.50
Raiffeisen Real Estate Fund	0.7	–14.4	44.89	0.42	–40.02	84.91	52.87	–47.13
CIB Real Estate Fund	0.4	–19.5	5.88	–4.05	–25.93	31.81	18.48	–81.52
Quaestor First Hungarian Housing Fund	–0.2	–5.0	1.96	–0.01	–0.13	2.09	93.78	–6.22
FirstFund Real Estate B	–1.2	–14.5	0	0	0	0		
FirstFund Real Estate A	–1.2	–14	4.52	0	–0.5	5.02	90.04	–9.96
MAG Real Estate Fund	–0.5	–19.4	1.84	–0.01	–0.99	2.83	65.02	–34.98
Biggerge's-NV4	–7.1	–55.4	3.91	–0.29	–6.54	10.45	37.42	–62.58
Access Real Estate Fund	–7.5	–27.6	0.69	–0.14	–0.93	1.62	42.59	–57.41
Futureal 1. Real Estate Fund	–8.2	18.5	6.59	–0.59	6.59	0	0.00	
Reálszisztéma	–16.6	–23.6	1.18	–1.51	–2.68	3.86	30.57	–69.43
Erste Euro Real Estate Fund	–	–	7.47	7.47	7.47	0		
Total:	**0.3**	**–10.2**	**258.14**	**–29.96**	**–285.35**	**543.49**	**47.50**	**–52.50**

Source: own calculations

here? For a better understanding we must review the effects of the global economic crisis.

THE CRISIS

"Fluctuation" in the portfolios of the real estate funds

If we look at Table 2, which shows changes in the net assets value of real estate funds in the Q1 of 2007–2009, we can see that the real estate funds were affected by the crisis in *several stages.*

The first major drop in assets occurred in the period between Q4 of 2006 and Q2 of 2007.

After that one could witness another growth in assets, which lasted until Q1 of 2008, and which practically offset the loss of assets experienced in the preceding period.

However, assets continued to drop throughout the next period, which can be explained in part by the redemption of investment units, asset withdrawal, as well as by the drop in the value of properties and other assets in the portfolio of the real estate funds. As a result of this process, by 30 September 2009 the assets of real estate funds decreased to less than 50 per cent of the (peak) value experienced on 31 March 2008.

Reasons behind the situation that emerged

It would be easy to explain the crisis that evolved and all losses of assets with the "situation that developed as a result of the crisis", and attribute all these processes to a single cause. Unfortunately, apart from the crisis several other causes must be mentioned too, and for the sake of fairness we should first "sweep before our own door".

The strongest factor among the general, non crisis dependent causes was and still is the low level of financial culture, which is apparent both among customers' (investors') and fund managers.

The other general cause is implied in the general financing rules of real estate funds. The environment that changed as a result of the financial difficulties caused by the crisis explicitly brought these problems to the surface.

From among environmental changes the radical change in the domestic financial framework conditions must be highlighted: the rise in interest rates (both in the case of deposits and state bonds), the extension of state guarantee on deposits, unfavourable changes in real estate market processes, loss of investors' trust.

Based on a brief analysis of the major correlations between these "non-crisis related" factors in the first place it can be concluded that the *low level of financial culture on the customer's or small investor's sides* manifests (manifested) itself in the fact that the customers/ small investors were not and are still not very much aware of the *time horizon of their investments:* they are not aware of the fact that real estate investment funds are for medium or long-term investments that can yield adequate revenues in 5 to 10 years in general. In most cases the increase in the quantity and quality of properties in the portfolio yield the desired result only in the longer run. However, such a long investment period also implies that the value of properties may temporarily fall, for instance, in line with the economic cycles, which also means a decrease in the value of investments. Another problem is that investors usually fail to assess their own way of life. They do not assess how changes in the economic processes could affect their investments. Nor do they assess how soon they will/may need their savings, and how that period correlates to the optimum period of their investments.

The lack of financial culture on the *service suppliers' side* manifested (manifests) itself, among other things, in that they failed to ask

Table 2

THE NET ASSETS VALUE OF INVESTMENT FUNDS, 2007–2009

(billion HUF)

Description	31. 03. 2007.	30. 06. 2007.	30. 09. 2007.	31. 12. 2007.	31. 03. 2008.	30. 06. 2008.	30. 09. 2008.	31. 12. 2008.	31. 03. 2009.	30. 06. 2009.	30. 09. 2009.
Investment funds	2,634.157	2,849.215	3,124.488	3,235.766	3,189.304	3,049.041	3,070.164	2,566.599	2,539.088	2,544.578	2,897.490
I. Public funds	2,549.301	2,748.910	3,023.370	3,125.368	3,084.633	2,929.271	2,939.622	2,362.234	2,249.315	2,240.292	2,496.737
1. Securities funds	2,085.916	2,288.179	2,551.562	2,627.684	2,578.927	2,439.047	2,465.584	2,015.864	1,950.595	1,996.015	2,244.605
Bond funds	1,090.680	1,219.533	1,307.528	1,346.964	1,380.817	1,293.565	1,289.927	1,042.154	1,063.674	1,082.111	1,254.506
Mixed funds	83.891	93.195	105.212	110.834	107.478	96.490	86.193	68.399	76.015	74.240	76.104
Equity funds	158.588	178.683	207.923	207.255	185.367	171.843	171.018	129.390	247.104	286.500	370.877
Funds investing in derivative transactions	313.818	352.858	460.364	501.228	524.988	548.059	561.329	557.471	40.127	41.030	47.042
Guaranteed funds									470.351	443.575	429.389
Other, not classified funds	438.939	443.910	470.535	461.404	380.277	329.090	357.116	218.449	53.323	68.559	66.687
2. Real estate funds	463.385	460.731	471.808	497.684	505.706	490.224	474.037	346.370	298.720	244.277	252.132
Real Estate Trading Fund									296.403	243.002	249.099
Real Estate Development Fund									2.317	1.275	3.033
II. Closed-end funds	84.856	100.304	101.117	110.397	104.672	119.770	130.543	204.365	289.773	304.286	400.753

Source: HFSA

the customers about their intentions, and sometimes failed to provide information about the risks implied in the given investment. Naturally, the appropriate references can be found in all information leaflets, websites or contracts. However, taken the level of the customers' knowledge, as well as the time available or spent on administration, this is not sufficient. It is also related to financial culture that real estate funds were most often established by financially sound banks – in order to increase their product line – that gave their names to this form of investment. And this made the investors believe that being part of a group was also a guarantee for payments.[2]

The other general problem is implied in the maturity periods of the *financing* of real estate funds, as well as in the composition of the fund's liabilities and assets. In the case of open-end real estate funds resources contain non-fixed maturity investments (i.e. the customers may redeem the investment units and withdraw their money from the fund at any time). In contrast with this, the assets side include real estate investments that can be sold in the medium or long run only. Therefore, open-end real estate funds carry money market characteristics, too, which make them rather vulnerable, as it has been shown by the events of the past few years. In addition, with a view to serve investors even better, open-end real estate funds reinforced this money market type feature – which in my opinion indicates the lack of financial culture – by reducing the maximum redemption period of $T+90$ days to the shortest possible period of $T+2$ or $T+3$ days. And redemptions within two or three days contradicted to the investment time horizon shown in the information leaflet or the management regulations. These short redemption periods suggested that such investments are liquid, or can be made liquid, i.e. savings can be taken out at any time with a significant yield.

This attitude caused no problem as long as investments flowing into the real estate funds, and the *liquid assets* provided coverage for the redemptions. Financing from current revenues and liquid assets could be maintained for a long time, since the real estate exposure of the Hungarian real estate funds was low. (This level was higher, reaching 50 to 60% before 2006, too.) However, due to the large-scale tax optimization related to the introduction of the interest tax, the invested assets were insufficient for the purchase of properties. Therefore, based on the situation that evolved around the real estate funds, it can be said in hindsight that the low level of real estate exposure had a very fortunate and "positive" effect: these "uncommitted liquid assets" made it possible to normalise the processes and avoid liquidation, as well as an even greater loss of trust. On the other hand, criticism is rightful: most of the profits of real estate funds came from sources other than properties, since they achieve appropriate profits not (only) through their real estate investments. (And it should have been taken into account that there exist other investment instruments for the investment of funds into securities that are more appropriate in certain aspects.[3])

After reviewing the general, non crisis related causes it is also worth investigating the processes triggered by the *general economic crisis stage by stage.*

The economic crisis first reached the Hungarian economy through the financial sector, including especially the banking sector. The abundance of resources disappeared, and for financing former loans and assumed commitments the banks needed additional resources. On top of that, at the same time the state also lay claim to additional resources on the market. Therefore, the banks and the Hungarian state cooperated, each working for the solution of their own problems, and raised the interest level higher and higher. Consequently, high interest rates acted like a magnet in attracting small investors who were only aware of the fact that

banks were willing to give a 10 to 15 per cent interest. (It shows the lack of financial culture that the advertisements used at the time did not mention other risks associated with a short maturity period.)

The rise in interests reduced the demand for investment units. This dried up fresh resources, and significantly deteriorated the exchange rate of the investments of real estate funds in government securities. Consequently, government securities owned by the real estate funds also considerably devalued. As a result, the market value of real properties also dropped, or at best remained constant. Therefore, the affected real estate funds were forced to reduce the exchange rate of their investment units.

As a result of the unfavourable changes, capital withdrawal from the funds started, too. When looking for new investment opportunities the investment unit holders also examined which of their existing investments yielded revenues or the least losses when being liquidated. And these investments turned out to be the ones in real estate funds, since the disadvantages arising from the exchange loss of debt securities were significantly mitigated by the unchanged value of the real estate portfolio.

Fordítói megjegyzés, inkább nem nyúlunk bele a formázásba, mert nem értünk hozzá: Lévai kérése alapján, 4. oldalon alul, ahol az Európa Ingatlanalapról kezd írni a szerző, azután folytatja az 5. oldalon aza Erste, majd pedig OTP Ingatlanalappal és a 6. oldalon lezárja ezt a Raiffeisen Ingatlanalappal, ott az ezekről szóló szöveget hozhatnánk oldalléniával és kisebb betűvel, mert tele van részletekkel és számokkal, mintegy illusztrációja a mondanivalónak.

This in turn shook the position of the real estate funds; which I proved by examining four real estate funds that were considered to be the largest ones before the crisis (had a capital of at least HUF 30 billion).[4]

Európa Property Fund

- *In March 2008 the Fund had a net assets value of HUF 40,575 million, the exchange rate was HUF 1.5974 per investment unit, the real estate exposure compared to the net assets value was 89 per cent, and the value of the real estate portfolio totalled HUF 36,237 million. The fund owned liquid assets worth HUF 16,398 million, and had a debt of HUF 12,060 million.*[5]
- *By October 2008 the net assets value of the fund dropped to HUF 26,665 million, which meant a more than 34 per cent loss. At the end of the month the debts of the fund totalled HUF 12 billion, the value of its real estate portfolio equalled HUF 35,022 million, and despite the debts of HUF 12 billion liquid assets hardly exceeded HUF 3.6 billion. In October as much as HUF 7.55 billion worth assets were withdrawn, however, the net assets value hardly changed compared to the previous months. The 0.84 per cent drop compared to the previous year can be explained with the losses on state securities, too.*
- *In the past one year the fund did not regain its net assets value, and its value in October 2009 was only little over 72.5 per cent of the value accounted one year earlier.*

The largest real estate fund of Hungary is Erste Real Estate Fund

- *At the end of Q1 of 2008 the Fund's net assets value equalled HUF 150,325 million, and the net assets value per unit totalled HUF 1.3902. The fund's relative real estate exposure compared to the net assets value was nearly 40 per cent. The fund had HUF 119,946 million in liquid assets and HUF 29,627 million in loans.*
- *By October 2008 the net assets value of the fund decreased to HUF 116,613 million, which meant a net assets value loss of HUF 22 per cent. By the end of the month the fund's debts grew to HUF 32.5 million. The real estate portfolio of the fund increased by nearly HUF 5*

billion to HUF 65.944 million, while liquid resources exceeded HUF 83 billion despite a debt of HUF 32 billion. Compared with other real estate funds, asset withdrawal from this fund was not significant in October. Even if the growth of debts and the value of real estates are calculated in combination with the drop in liquid assets, reduction was below HUF 6 billion. At the same time, the net assets value per unit did not decrease either. On the contrary, it slightly increased. On one hand, this can be explained by the fact that Erste Bank backed the real estate fund already before the crisis emerged. On the other hand, the fund owns several real properties that generate revenues on a continuous basis. Therefore, while continuous liquidity was ensured from uncommitted resources and loans, the real estates did not have to be devalued, which provided a favourable position for the fund and the fund manager in the market competition.

The second largest real estate fund in Hungary is OTP Real Estate Fund

- *At the end of Q1 of 2008 the Fund's net assets value totalled HUF 146,272 million, and the per unit net assets value equalled HUF 1.5439. The Fund's real estate exposure compared to its net assets value hardly exceeded 34 per cent, and the real estate portfolio was valued at HUF 54,319 million. The Fund had HUF 95,262 million in liquid assets, and HUF 3,309 million in loans.*
- *By October 2008 the Fund's net assets value decreased to HUF 90,483 million, which meant that it had lost more than 38 per cent of the net assets value. By the end of the month the debt portfolio of the Fund grew to over HUF 16 billion. At the same time, its real estate portfolio totalled HUF 58,096 million. Despite the HUF 16 billion worth of debts, the Fund's liquid assets exceeded HUF 48.5 billion. However, in October HUF 40.6 billion worth assets were withdrawn, compared to which the assets portfolio of HUF 48.5 billion no longer seems to be very big. However, at OTP Real Estate Fund one could already witness a greater, 2.23 per cent drop in the exchange rate, which could only partially be explained with changes in the exchange rates of government securities.*

Raiffeisen Real Estate Fund

- *In March 2008 the Fund's net assets value equalled HUF 90,751 million, while the per unit exchange rate was HUF 1.7305. The Fund's real estate exposure compared to the net assets value totalled 56 per cent, and the real estate portfolio was valued at HUF 50,820 million. The Fund owned HUF 40 billion in liquid assets.*
- *By October 2008 the Fund's net assets value dropped to HUF 66,128 million, which meant a loss of 27 per cent of the net assets value. The Fund's real estate portfolio totalled HUF 56,208 million, and its liquid resources equalled HUF 9,919 million. In October as much as HUF 18.573 billion worth of assets were withdrawn, while the net assets value hardly changed compared to the previous month. The 1.18 per cent drop compared to the previous month can also be explained with the loss on the sale of government securities.*

The picture looks more complex if we examine separately cash withdrawals in the last days before the "difficult decision". The HFSA issued its resolution on 7 November 2008 in which it suspended payments, wherefore data for November reflect payments made in the preceding five working days. Unfortunately, the last column clearly shows that based on cash withdrawals in the last five days *(see Table 3) certain real estate funds could have become insolvent by the end of November 2008.*[6]

In summary, it can be said that had the above processes continued, three of the four large funds would have become unable to finance –

Table 3

ESTIMATED CASH WITHDRAWALS IN NOVEMBER 2008

	October assets	November assets	Change in assets billion HUF	Change in assets per day million HUF	Liquid assets in October billion HUF	Number of days of solvency
Európa Property Fund A	26,668	23,474	–3,194	–639	3,676	6
Erste Real Estate Fund	116,613	113,831	–2,782	–556	83,127	149
OTP Real Estate Fund	90,483	77,773	–12,710	–2,542	48,576	19
Raiffeisen Real Estate Fund	66,128	53,134	–12,994	–2,599	9,919.2	4

Source: own calculations

without taking out additional significant loans – the continuously growing number of redemption orders in November 2008. Since real estates could not be sold due to the shortage of time. The market would have been unable to absorb more than HUF 268 billion worth of mostly specifically designed office, retail and industrial real estate other than through forced sales, or at unrealistically and senselessly reduced prices, which would have been harmful for everyone. On the other hand, Erste Real Estate Fund, where real estate exposure remained continuously at a low level, could achieve a better position. Therefore, its liquid resources were sufficient to finance great demand. Yet, the debt ratio was extremely high at this Fund, too.

What opportunities were available?

In the legal environment effective in November 2008 the various players – investment funds, owners, the Hungarian state and the HFSA – had at their disposal, both in theory and legally, well over a dozen of possibilities to handle the "intensifying situation".

Where the *fund manager,* i.e. the organisation responsible for the real estate fund wanted to solve the insolvency related problems, the following solutions could be considered:

❶ *taking out a loan,* which cannot exceed 10 per cent of the equity, and can have a maximum maturity of 30 days. However, this possibility is available only in theory, since almost all fund managers have already used this possibility;

❷ *lending* 30 per cent of the *securities* held by the funds, which could have provided additional liquid assets to the funds. The implementation of this option was hampered by the fact that by the beginning of November most fund managers had already sold their liquid securities;

❸ the fund manager could have asked its *owner* (group) to purchase the investment units redeemed by the customers, and this would have provided additional resources. This method of resource acquisition was hindered by the fact that the owners were also short of free assets to inject cash into the fund by buying investment units;

❹ *the fund manager could have asked for the suspension* of the fund, but this was not possible due to the fact that there existed no unavoidable external causes that would have provided a legal background for suspension;

❺ *revaluation of real estates,* setting prices that reflect the economic processes, which is a longer procedure requiring several days or even weeks. In addition, this would not have meant a real solution, since the expected devaluation would have not significantly decrease the rapid

growth in immediate (prompt) payment demands;

❻ *modification of the trading rules,* i.e. changing the $T+3$ days rule to $T+90$ days was in theory a realistic option, however, due to the time intensiveness of the modification, it would have not solved the payment difficulties in many cases;

❼ *the sale of real estates* from the fund's portfolio, which is a longer process requiring several months, and would have forced the owner to incur a significant loss. During forced sales the price would have been much lower than the one achievable under normal market conditions. However, it must be noted that another precondition for this scenario is the existence of a player that is willing and able to buy the property at a realistic – or at any – price. In November 2008 there were not too many such applicants.

❽ *declaring insolvency,* but only when the fund manager is no longer able to comply with its obligation regarding the redemption of the fund's investment units. At the end of the liquidation procedure that would start afterwards the claims of the investment unit holders would have been satisfied in part or in full. However, this move would have triggered negative and panic-inducing effects that would have increased further redemptions;

❾ *modification of the communication strategy,* enhancement of activities aiming to convince investors. The managers of real estate funds would have had the opportunity to give a better presentation of their investments through conscious communication and by using the forums of the press, and thus they could have suggested security and preserved their strategic investors.[7] This solution would have been sensible since the real estates were "good" and also available: they physically existed, and fund managers had long-term lease contracts on them.

A number of possibilities were available for the *owner (group) of the fund manager,* too:

❶ it could have helped the fund manager by *purchasing investment units,* which could have ensured continuous liquidity, had the owner financial institutions not been short of liquid assets themselves;

❷ however, *purchasing the real estates* owned by the fund manager would have increased the capital requirements of the financial institutions at a time, when "money should have been injected into them" for other reasons, too.

The *Hungarian state* would have also had the possibility to

❶ buy *investment units* from the fund manager through its institutions – e.g. National Bank of Hungary, Hungarian Development Bank, Hitelgarantiqua, etc. – however, this was hindered by the scarcity of available state resources;

❷ *purchase the real estates* owned by the fund manager in order to maintain continuous liquidity, for which even less budgetary resources were available;

❸ modify the *legal regulations* in a manner that would have enabled fund managers to respond to the situation more efficiently. However, this move would have required several weeks due to the need for legal amendments.

In this situation the *HFSA*

❶ could have made the *market players and market processes* solve the problem, which would not have violated the law, and on this basis the possible bankruptcies and acquisitions would have led to the cleansing and strengthening of the market,

❷ could have enforced responses to the situation that emerged by focusing on the fund managers of the *most hardly hit* fund(s). However, measures taken against the individual institutions could have caused panic among the investment unit holders, who would have "stormed" not only the affected fund or fund

manager: probably even greater cash withdrawals would have occurred from all funds,

❸ could have taken a common measure for *all real estate managers,* which would have provided certain amount of time for the entire fund managing sector to prepare and rapidly take the necessary measures.

As it can be seen from the list of 17 presented above several market-based and less market-based solutions would have been available for the management of the crisis situation, out of which only one known decision seemed feasible, and – judging from the criticisms related to this solution – in retrospect, maybe one other realistic solution could have come into play. The *known solution* was the HFSA resolution, according to which in all public or closed, open-end real estate funds, or public investment funds investing in open-end real estate funds *trading with investment units was suspended for ten days.* Based on this requirement of the resolution, for ten days investment fund managers had to publish the exchange rates of the investment units of real estate funds on a continuous basis, and they were mandated to accept orders for the redemption or purchase of investment units. However, investment units could not be traded, i.e. no payments were made into or out of the funds. (In this case the emphasis is evidently on the postponement of payments made out of the funds). At the same time, the HFSA resolution also required the modification of the *management rules,* which meant that the maximum time lag between the acceptance of redemption orders and the value dates of settlements had to be modified. In the case of real estate funds it meant a period of maximum 90 days, while in the case of funds of funds (e.g. funds investing in real estate funds) it meant a period of maximum 30 days. The resolution also made it possible for the fund managers to modify the former *settlement deadlines* of $T+3$ days to maximum 30 or 90 days. It is important to note that the HFSA only created the possibility: the fund managers could leave the settlement deadlines untouched. However, such a decision was not made, i.e. all market players extended the settlement deadlines in their best interest. Most fund managers set a deadline of 90 days, however some set shorter deadlines.[8]

WHAT CONSEQUENCES DID THE HFSA DECISION ENTAIL?

In this situation the old saying "time is life" really held true. The immediate effect was that after the publication of the HFSA resolution (on a Friday) the investment units of open-end, public real estate funds and of the "funds of such funds" could not been redeemed. What is more, redemption orders placed earlier, but unrealised by 7 November could not be fulfilled either. The resulting ten-day "trading break" allowed fund managers to modify their Management Regulations. Therefore, they had some more time to thoroughly reconsider the financial situation.

During said break the fund managers took several measures to reinforce their liquidity, too. One of these measures was the exploration of further *borrowing possibilities,* the basis for which was created only by the amendment of Act CXX of 2001 on the capital market (hereinafter: Capital Market Act) effective as of 24 November 2008: according to this amendment, securing liquidity can also be accepted as a borrowing objective. On the other hand, it became possible *to sell real estates in a "sober" and well thought through manner;* however, such transactions were made only in a limited number and affected only a limited amount. Thirdly, in the case of most funds the real estates owned by the funds were revaluated, and their value was radically decreased in several cases. As it can be seen from the last column of Table 1, certain

real estate funds had negative yields of 15–20 per cent, which was significantly due to the devaluation of properties.

The available time should have been sufficient for *the legislators* to take the measures that could have helped overcome the crisis.

For *consumers and investors* the HFSA resolution and the subsequent decisions of the fund managers were clearly adverse. Suspension of trading and the modification of the management rules protracted the realisation of redemptions and made the size of the redeemable amounts uncertain, since the investments could be turned into liquid assets only in 90 days, and only at the exchange rate valid on that very day. This step created a difficult situation for those who regarded real estate investment funds as liquid resources and wanted to use the paid amounts to meet their fixed-term obligations. (Some small investors who felt aggrieved attacked the HFSA resolution in court.)

This also caused a problem in the *insurance sector.* In the case of unit-linked insurance policies that invested into real estate funds the redemption obligation undertaken by the insurance company had to be fulfilled (a $T+3$ days deadline for settlements and redemptions was also typical in that sector). Once the real estate funds published their per unit net assets value, the insurance companies could also disclose their exchange rate to their clients, and on the basis of such exchange rate they also had to comply with their redemption obligation. Due to this uncertainty, some insurance companies did not undertake, and in fact suspended the redemption of their unit-linked insurance policies in the transitional period.

In the case of *private and voluntary pension funds* that appeared as major investors in real estate funds the suspension of trading and the subsequent modification of the management rules did not cause any major problem, since the portfolios of these institutions can contain only limited real estate related investments.

Real estate investment funds that were not threatened by imminent insolvency, were also critical about the HFSA resolution: they were also affected by the loss of investors' trust that "appeared" as soon as the decision was passed, and this significantly influenced their normal flow of business.

CRISIS MANAGING LEGISLATION

At last, *legislators* acted promptly when the crisis became more serious. Amendments to the Capital Market Act aiming at resolving the problems took effect as early as 24 November 2008. (After the expiration of the ten-day suspension of trading the amendments to the legal regulations created a new set of tools for the real estate funds and the HFSA to overcome similar situations[9].)

The provision that allows the HFSA to act in favour of the investors was significantly supplemented, as a result of which (real estate) funds were also given the possibility to request suspension. According to the legal regulations, investment fund managers could now ask the HFSA to suspend the trading of investment units for up to 180 days, if this was justified by the investors' interest. The Act provides for such suspension after the 5th trading day following the "event", in three cases specified therein. (It is true, however that the HFSA must make a decision within two trading days, since these are the cases that most jeopardise the security of the market.[10]) 180 days are a very strict deadline for such a fund, since in case suspension is not revoked within this period, the HFSA must order the liquidation of the fund. However, within the 180-day period both the HFSA and the fund manager can initiate – independent of each other – the termination of

suspension, and the resumption of trading with the investment units of the fund. This allows the HFSA to prevent the fund manager from unjustifiably prolonging the non-trading period. At the same time, the manoeuvring room of the HFSA reduced in other fields, since the former provisions that gave cause to suspension ceased to include the reference to the investors' interests: this provision was transferred to the competence of the investment fund manager.

A significant change was brought about by the option according to which *an open-end public real estate fund could be converted into a closed-end real estate fund.* The possibility of conversion meant that real estate funds that formerly issued open-end investment units, i.e. ones that they were mandated to redeem could be converted into real estate funds the units of which became listed on the stock exchange. This meant that trading could be continued, however, the fund manager was bound by the redemption obligation only after the expiry of the maturity period.[11]

The third major modification was the amendment of Section 271 of the Capital Market Act, which allowed that *for the sake of ensuring liquidity fund managers could take out loans* equalling up to 50 per cent of real estates taken into consideration during the calculation of the net assets value of the fund.

LESSONS LEARNT, RECOMMENDATIONS

❶ In my opinion, the *greatest problem of legal regulation is the form of the real estate investment funds.* The legal provision, according to which in the case of *open-end public real estate funds* the investment fund manager must assume a maximum 90-day redemption obligation for the investment units hinders assets and liabilities management. Due to the redemption obligation, long-term investment is financed from classic short-term resources. (This problem could already be encountered in the no longer existing real estate cooperative sector.) This environment *always implies* the risk of insolvency due to cash withdrawals. The market of facilities included in the portfolios of real estate funds is smaller, consequently, the group of potential buyers is limited, too, which on one hand prevents rapid sales, and on the other hand, the "salvage value" arising from forced selling can cause losses for the investors.

This problem can be solved in two ways:

- it must be banned to set up open-end real estate funds (similarly to real estate development funds),
- or the minimum time horizon of the redemption obligation must be linked to the average selling time of the real estate investment in the portfolio, in contrast with the current limitation setting the maximum time horizon.

A tool for retaining the open-end form is if someone purchases a call option for the assets of the real estate fund, or the fund manager ensures continuous liquidity. In this case the redemption period can even be short, for example $T+2$, $T+3$ days, since the partner behind the fund manager is obliged – and is hopefully able and willing – to ensure the necessary liquid assets at any time.

This decision would probably radically decrease the appeal of real estate funds among small investors. However, this could prevent investors who are unable to assess the risks of their investments from getting into situations that would later cause significant losses.

❷ A significant problem with the *funds of real estate funds* is that the redemption period of the funds in which these funds invest may differ from the redemption period of the "funds of funds". A solution to this situation could be the adjustment of the redemption

period to the fund with the largest share, or to the one with the longest redemption period.

❸ The reliability and independence of the work of persons and organisations *engaged in real estate appraisals* is a determining factor for the entire industry. Therefore, it can be regarded a bit anomalous that the value of real property did not change until October 2008, and then within two months radical losses of value were accounted. The question is raised: are appraisers really independent, and do they really act in the interest of investors? Here we encounter the typical "principal-agent" problem: property appraisal is ordered and paid by the real estate fund manager. This implies the risk that in case a dispute arises between the fund manager and the real estate appraiser, the former may cancel the contract and commission a new, "more flexible" real estate appraiser. As a solution I could imagine a better segmentation of the existing HFSA registry of real estate appraisers: appraisers could be divided by property type or size. The price of the job should be fixed by regulation. Then, real estate appraisers could be appointed to the job from the category assigned to the given property type or size, at random or on the basis of "card distribution". The fund manager should be mandated to sign a 3–5 year contract with such real estate appraiser, and should be allowed to terminate the contract only in well justified cases.

❹ Transparency could be fostered by the transformation of the current system of real estate appraisal that would require the establishment of a *real estate appraisal "council"*. This council would comprise of three real estate appraisers, and only that value could be accepted during the calculation of the per unit net assets value, that is accepted by all three appraisers. This would marginalise the "principal-agent" problem detailed above. (And real estate appraisers would also check one another.) Checking would improve if the real estate appraisals they prepare were published or made accessible for everyone.

❺ The investment rules must be significantly reconsidered. In 2008 several real estate funds held *most of their free funds in government securities and other investment forms specified by law.* Thus they assumed the risks of the money market instead of the real estates. Real estate funds were made competitive in the short run, too, by the new, non-real estate based investment possibilities, which broke away from the risks of real property. Apart from making a false appearance, this possibility also discouraged the funds from investing into real property.[12] Therefore, the investment possibilities available for free funds must be reconsidered and significantly decreased: for instance, such funds can be put into bank deposits for maximum one year. On one hand, this would encourage the real estate fund managers to look for good real estate investment possibilities, and on the other hand, it would refrain the excess marketing and sales promotion activities of fund managers. Since in case of excessive inflows of money investments meeting the investors' needs cannot be made either. The reduction of the rather broad possibilities of borrowing should also be considered (ensuring liquidity). Loans necessary to maintain liquidity must be made available in the future, too, however it is recommended to reduce the loans taken out to finance investments. This would ensure a type of gearing that would allow organisations (e.g. banks) standing behind the funds to implement investments that they could otherwise be unable to finance due to the legal provisions in force.

❻ And finally: in the future greater attention must be paid to *authorisation*. With regard to the framework rules specified in the Capital Market Act, the conditions defined there must be filled with real content by the authority granting the authorisation, i.e. HFSA. Within this framework the soundness

of the business policy and business plan of the real estate fund planned to be launched by the fund manager, as well as feasibility under the given micro- and macroeconomic conditions must be examined. Furthermore, it must be examined how realistic the market players' expectations are compared to the general market expectations. In case the authority believes that the conditions formulated in the management regulations cannot be met, the negative decision must be firmly assumed, i.e. the fund shall not be authorised.

* * *

The processes that happened could not have been evaded, however their impacts should/could have been handled better than in the past period.

Only a few real estates will be sold due to the delayed crisis of the real estate market and the later recovery from the crisis, since none of the managers of the major real estate funds would undertake the loss. At smaller real estate funds, where mere existence is at stake, sales may take place in the coming period.

I expect that in the next one to three years only a limited amount of fresh capital will be injected into the real estate funds by small investors, in part due to the low rate of return compared to the invested resources, and in part due to the lack of trust that has emerged and the long accounting deadlines. However, due to liquidity problems, real estate fund managers will presumably cut back on marketing campaigns supporting the sales of investment units, "in fear of" a similar cash withdrawal.

I judge certain groups of institutional investors differently (pension funds, non-unit linked products of insurance companies), for which investments in real estate funds may be profitable in the long run due to the favourable exchange rates (which started to grow after a significant devaluation). Institutional investors may also stabilise the market, since they are aware of the characteristics of medium-term investments, and they are not expected to liquidate their investments in response to a temporary drop in the exchange rate.

However, my expectations are mixed for the longer run. After the end of the crisis everything will return "to the way it was". For me this means, on the one hand, that in parallel with the decrease in the rate of return on government securities and deposit interest rates, and the recovery of the real estate market, real funds will again be able to achieve desirable rates of return for their investors. On the other hand, the selling competition will start anew, networks will offer such investments to all again, independent of the time horizon of the investments or the life conditions of the investors. We will face similar problems in 10 to 20 years unless legislators pass regulations for risk mitigation and aversion.

Notes

1 The study, which is based on a longer paper written by József Szűcs – The legal regulation and economic status of real estate funds (Budapest, manuscript, December 2009) – reflects the author's private opinion, wherefore it cannot be regarded as the opinion of the HFSA.

2 For a long time this held true within the normal operational conditions of the money and real estate markets, since the financial groups are usually banks the managers of which provided the real estate funds with insignificant but necessary amounts and for a temporary period in order to tackle liquidity problems.

3 In the course of 2005–2006 the press heralded several times that the real estate funds – in order to increase the yields despite their poor real estate portfolio – used the borrowing opportunities provided by

the law, and together with the resulting stock exchange transactions they yielded significant profits. Then the rightful, regulation related question was asked by many: how different are then real estate funds from bond investment trusts?

[4] Unfortunately, my analysis is supported by the fact that the problems discussed in connection with the large funds were even more substantial in the case of smaller funds that lacked support from financially sound larger banks.

[5] The available quick reports that contained monthly data did not always show the detailed composition of claims, liabilities and assets, wherefore I used simplification during the calculations. Since all quick reports indicated the level of real estate exposure and debts, I started out from the fact that the net assets value reduced by the real estate portfolio and increased by loans gives a good picture about the portfolio of net assets. I am aware of the fact that this is a significant simplification, however it provides sufficient grounds and facts for the general presentation of the situation of real estate funds, since the additional information obtained from the calculations offsets the inaccuracies of estimation.

[6] The situation was made even more complicated by the fact that fortunately by that time the per unit net assets value had significantly dropped only at the Európa Property Fund (by 3.75 per cent).

[7] In connection with communication it can naturally be raised that in the mood experienced in October 2008 all press appearances could have backfired: both the press and small investors would have started out from the well-known saying of "there is no smoke without fire".

[8] In the case of Erste Real Estate Fund the Erste Fund Manager decided that the deadline for redemption shall be $T+31$ calendar days from 1 December 2008, and $T+5$ trading days from 11 May 2009.

[9] The less than two page long Act LXXIV of 2008 amending Act XX of 2001 on the Hungarian Development Bank Plc. contains only one passage on the Hungarian Development Bank itself. The other provisions significantly changed the manoeuvring room of the real estate funds.

[10] Due to hasty law-making, a small error occurred. The 15 per cent liquid asset ratio is a minimum value in the case of real estate funds, i.e. if the ratio of liquid assets decrease below this level, the HFSA shall take measures to enforce the legal regulations, independent of the fund manager's request.

[11] The law is quite succinct in formulating the preconditions for conversion into a closed-end fund. Therefore, in CEO Letter No. 7/2008 the HFSA defined further conditions that it found to be important during conversion.

[12] However, in the second half of 2008 low real estate exposure was one of the fortunate and necessary preconditions for maintaining operability and liquidity, and this must be especially highlighted.

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