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Public consultation on the ECB framework regulation

Annex

The Danish mortgage system

Danish mortgage banks are specialized banks, which only grant loans against mortgages on real property by issuing covered bonds. Loans are granted at loan-to-value (LTV) ratios of up to 80% for private residential loans and typically up to 60% for other purposes, including commercial purposes. Mortgage banks have only one source of funding: bond sales. Thus, a mortgage bank does not operate in the same way as a commercial bank, which may take deposits or raise money market funding.

As the mortgage system is based on a principle of matching, all loans are matched with certain bonds (see chart 1). The loan type, repayment profile, term and currency thus determine which bonds the mortgage bank will sell. This ensures transparent loan costs, market-based prices, and unique prepayment options for borrowers. The match funding principle applies to all loans. In connection with adjustable-rate mortgages, the maturity of the underlying bonds is generally shorter than the loan terms. Here the match funding principle applies to the individual interest periods between refinancings. When the loan is refinanced, the underlying bonds are replaced. Further, the adjustable-rate mortgages are constructed in a way that ensures that the borrower (and not the mortgage bank) has the full refinancing risk – any change in interest rates is fully transferred to borrower.

All loans are funded on a current basis (tap issuance). That is, the mortgage bank issues the required bonds at the same time the loan is disbursed to the borrower. The prevailing market price consequently determines the loan rate faced by the borrower. In addition to the interest payment on the bonds, total costs also include a fee to the mortgage bank covering daily operating expenses and loan losses. Borrowers know which bonds fund their loans. As the bonds are listed on a stock exchange, borrowers can easily monitor market trends and thus the price they are paying. Borrowers may always prepay their loan by buying the underlying bonds in the market – this option is frequently used when market prices are in the favor of the borrowers.

Mortgage loans remain on the balance sheet of the issuing mortgage bank until maturity. The mortgage bank thus carries the credit risk on the loans until they mature. The mortgage bank thus have strong incentives to closely monitor the credit quality of its portfolio. In case of a loan defaulting, the mortgage bank will claim the underlying collateral (the real property). Danish law ensures a fast foreclosure process implying that the mortgage bank can easily access the collateral. Further, the borrower is subject to so-called full recourse liability which means that the mortgage bank can maintain a claim on the borrower, in case the realization of the collateral results in a loss for the mortgage bank.

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The Danish mortgage system is based on a one-to-one relationship between Danish mortgage banks' lending and issued mortgage bonds. The covered bond market plays a very important role in the Danish economy due to its size. By end of July 2012, outstanding covered bonds amounted to EUR 366 corresponding to approx. 150% of Danish GDP. In comparison, outstanding government bonds amounted to EUR 105bn. The Danish covered bond market is Europe's third largest with the German Pfandbrief market as the largest and Spain as the second largest.

Chart 1 – stylized illustration of the Danish mortgage system