FINANSTILSYNET

DANMARKS NATIONALBANK

MEMORANDUM

7 April 2010

Danish Mortgage Credit and International Regulation

Proposals for quantitative liquidity standards are being considered internationally as part of the follow-up on the financial crisis. The Danish Financial Supervisory Authority and Danmarks Nationalbank support the efforts to improve international regulation of the financial sector and find that the proposal contains many positive elements and is a step in the right direction. The proposal also gives cause for concern, however.

Danish mortgage credit is a key element of the Danish financial system. There is a risk that current deliberations concerning new international regulation may undermine parts of the system. These are primarily:

1. A new definition of liquid assets that fails to allow for the fact that Danish mortgage-credit bonds are just as liquid as many government bonds.
2. Liquidity requirements that make it impossible to maintain the present adjustable-rate loan model.
3. A leverage restriction that does not take into account the collateral pledged for mortgage-credit loans.

This memorandum describes the above three challenges in more detail. The Danish Financial Supervisory Authority and Danmarks Nationalbank have positions on other aspects of the proposal, but the focus here is on the above three.

Danish mortgage credit

The Danish mortgage-credit system is of major significance to the entire Danish financial sector and thus also to financial stability in Denmark. Its significance can be illustrated by the fact that the market value of all mortgage-credit bonds is approximately kr. 2,300 billion. In comparison, Denmark's GDP is approximately kr. 1,700 billion. The market value of the bonds is thus approximately 1.4 times Denmark's GDP.

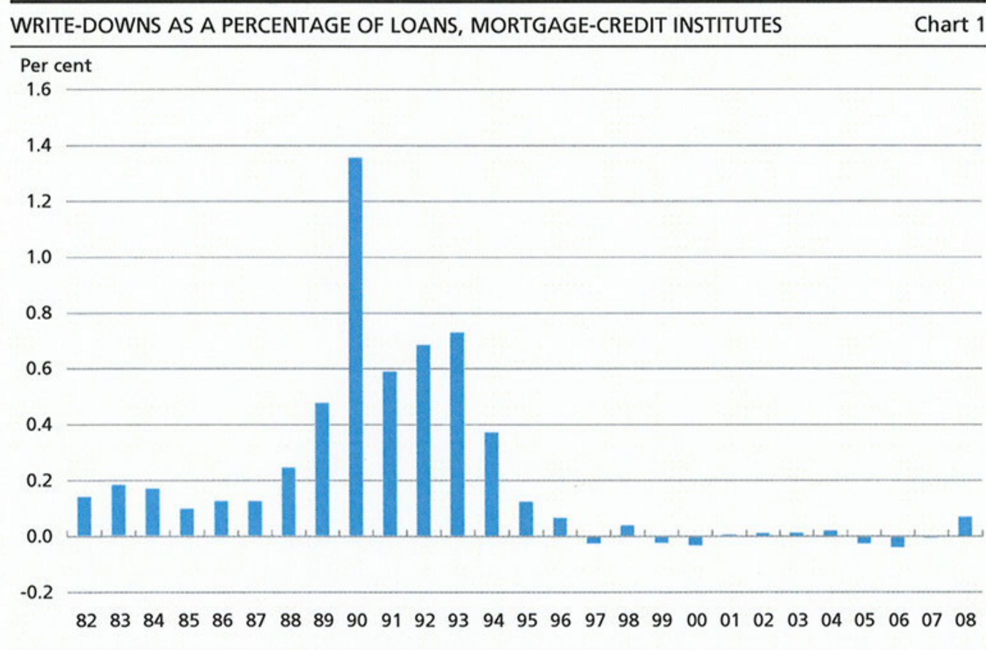
The Danish mortgage-credit system is highly efficient and transparent. Borrowers pay the market rate on the mortgage-credit bonds plus a fee of approximately 0.5 percentage point to the mortgage-credit institute. The yield spread between government bonds and mortgage-credit bonds is normally limited as the real property pledged as collateral gives mortgage-

credit bonds a very high degree of security. During periods without market turmoil the yield spread may be as low as 0.1 percentage point in e.g. the 2-year segment and 0.25 percentage point in the 5-year segment. This means that during such periods the overall borrowing rate will only be up to 0.75 percentage point higher than the government-bond yield.

From the investor's point of view it is a very secure product that has never led to credit losses. In practice, the mortgage-credit institutes achieve this level of security by solely granting loans against real property as collateral, financed by issuing mortgage-credit bonds. Furthermore, the "balance principle" limits the institutes' ability to assume risks other than credit risks. This ensures a close link between loans and bonds. Credit risk is limited by restricting the extent to which the properties can be pledged as collateral and laying down detailed rules on property valuation. In addition, bond investors have priority in the event of failure, and borrowers are personally liable for the loans. The lack of personal liability for the loans is a major explanatory factor behind the substantial losses on mortgage-credit loans in the USA. Finally, Denmark has a highly effective enforcement system.

The above characteristics make the bonds particularly secure investments while supporting Denmark's financial stability, cf. Chart 1, which shows the institutes' write-downs as a percentage of loans.

WRITE-DOWNS AS A PERCENTAGE OF LOANS, MORTGAGE-CREDIT INSTITUTES — Chart 1



The robustness of Danish mortgage credit can be illustrated by the fact that it was possible to sell bonds for refinancing of adjustable-rate loans in the amount of approximately kr. 350 billion during the financial crisis, albeit with a certain widening of the yield spread to government bonds. The mortgage-credit institutes were able to do this without incurring higher