Bill on safeguarding the Danish mortgage-credit sector

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Background

Adjustable-rate mortgage loans issued by mortgage-credit institutions are typically issued with a term of 30 years but these loans are funded by bonds with a significantly shorter term, e.g. bonds with a term of one year or three years (in the following adjustable-rate mortgage bonds). This implies that the loans continuously have to be funded. After the financial crisis the rating agencies and the EU have focused on the risk that in a stress scenario it could prove impossible to sell enough new bonds in order to refinance the underlying loans. In that case the risk is that the mortgage-credit institution will be unable to repay bond holders as promised which would result in a winding-up of the mortgage-credit institution. That would imply substantial economic costs to borrowers, investors and society.

On that background rating agencies require that the mortgage-credit institutions reduce their refinancing risk and the EU has similar requirements in the pipeline.

With this bill the mortgage-credit institutions' refinancing risk is removed. This is done by setting requirements to the mortgage-credit institutions' issuance of bonds when loans with a term of 30 years are funded by bonds with a term shorter than 30 years. The requirements imply that the refinancing risk in the future will be carried by investors and not by the mortgage-credit institution.

It is expected that the bill will make it possible for the mortgage-credit institutions to maintain short-term adjustable-rate mortgage loans.

Extension of the bond term

The bill specifies how the conditions behind the mortgage-credit institutions' adjustable-rate bonds should be made for the occasion that the institution is unable to refinance loans or for the occasion that the refinancing of loans implies a disproportionate increase in the borrower's interest rate.

Inability to sell enough bonds

The bill requires that the conditions behind the adjustable-rate mortgage bonds specify that the bond automatically may be extended for one year if the institution, e.g. in a situation with turbulence in the markets, is unable to sell enough new bonds to refinance the underlying loans. When this year has passed the institution may once again try to sell the new bonds. That will be possible if the problem to sell bonds is temporary. If it is not possible to sell enough bonds after this year the bond may be extended for another year.

When extended the bond's interest rate will, as a starting point, be the interest rate one year ago plus five percentage points. Should the bond term be extended for another year the interest rate is kept unaltered.

These rules ensures that an otherwise sound mortgage-credit institution will not become distressed in the very unlikely event that adjustable-rate mortgages cannot be refinanced. Thereby the mortgage-credit institutions' refinancing risk is removed.

Disproportionate increase in the interest rate
For adjustable-rate bonds with a term of up to three years it has to be part of the conditions that an interest rate increase of more than five percentage points than the effective interest rate the year before, the bond will be extended for one year and the interest rate increase will be limited to five percentage points. A borrower with for instance a loan on which the interest rate is adjusted every year cannot get an interest rate increase of more than five percentage points from one year to another. At the first refinancing of the loan after this year there is no limit on the interest rate.

The ceiling on the interest rate thereby protects borrowers against very large and sudden increases in the interest rate which could e.g. happen as a result of a transitory currency crisis. With the ceiling there will at the same time be limits on the institutions risk of loss, i.e. a situation where a large interest rate increase elevates the institution's credit risk due to a number of borrowers inability to service their debt after the increase in the interest rate.

A mortgage credit institution under resolution
For a mortgage-credit institution under resolution a similar model applies with just one exception. If the refinancing fails, or if the interest rate increases with more than five percentage points, the bond will not be extended for one year but will be altered to a long bond with term and installments corresponding to the underlying loan. At the same time the borrower's loan will be altered to a convertible loan with a fixed interest rate

This ensures clarity about the payments on bonds when a mortgage-credit institution is under resolution, and it also ensures that the uncertainty about refinancing of the institution's adjustable-rate loans is eliminated. This is a precondition for an orderly resolution of an ailing mortgage-credit institution.

Coming into force

The bill will come into force on 1st of April 2014 for new bonds with a term up to 14 months. For all other adjustable-rate bonds the law will come into force on the 1st of January 2015.