

The Danish Mortgage System

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How it works

- Four mortgage bank intermediaries
- Mortgages made highly uniform by regulation, but are available in fixed rate forms up to 30 years or more, and in variable rate forms.
- The mortgage banks are intermediaries. They hold the mortgages on their books and issue bonds to fund them

How it works (cont.)

- The bond buyer relies on the credit of the bank; the portfolio of mortgages is back-up collateral
- The bonds are issued in series or pools—all representing basically the same credit quality
- 80 % LTV requirement

How it works (cont.)

- Mortgages may be prepaid at any time
- Banks subject to “Balance Principle”
- Whenever they make a mortgage loan, must issue a bond of same maturity
- If mortgage is prepayable, bond is callable
- Mortgage bank takes no prepayment risk—bondholders do
- 150 bps over govts-- vs 140 for F&F callables

How it works (cont.)

- The bond is issued like new series from an existing pool
- Pool that has a uniform interest rate—e.g., 5%--nearest the market rate
- The rate on the bond is close to the government rate
- Mortgagee pays this rate, plus fees of the mortgage bank

Advantages

- Simple system that offers low fixed rates, variable rates and prepayment at any time, in whole or in part
- When interest rates rise, mortgagees can buy bonds at discount and reduce principal
- Banks take only credit risk—not interest rate risk
- Guaranty fund backs only credit risk

Disadvantages

- High LTV and uniformity reduces home ownership rate—51% in Denmark
- High capital requirement reduces ROE—perhaps not necessary
- Heavy regulation and uniformity suitable for Denmark but not US
 - Works for 4 banks but may not work for thousands

Overall

- The disadvantages are not fundamental
- Prepayment and interest rate risk not borne by government-backed entity
- Shows feasibility of Mortgage Holding Subsidiary structure, at least on small scale
 - In situ financing: bondholders rely on credit of bank, backed by mortgage collateral
 - Bondholders able to take interest rate risk