COFACE FAMILIES EUROPE

# SOCIAL POLICY AND MORTGAGE LENDING:

## THE DANISH MORTGAGE MODEL IN A EUROPEAN PERSPECTIVE

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On the 9th and 10th of November 2017, COFACE Families Europe and Finans Danmark co-hosted a seminar on financial inclusion and how to improve access to affordable and stable financing for European families, specifically focusing on access to mortgage loans. Aside from being an opportunity to exchange between various European stakeholders on the topic of financial inclusion, the seminar put a special focus on the Danish mortgage model, as one example of a financing model that has provided Danish home owners with inexpensive and stable financing for more than two centuries.

The seminar falls within COFACE Families Europe's work on financial inclusion, especially looking at access to mortgage credit, lending conditions (interest rates, business model of banks…), creditworthiness checks mechanisms, and more broadly within the European Pillar of Social Rights. Access to decent housing at an affordable price is a key concern all over Europe and is one of the many pre-requisites for social inclusion.

This report is divided into the following sections:

**I. A family's story: key steps to obtaining a mortgage in Denmark**

**II. History and foundations of the model: legal, welfare and housing context**

**III. Pros and cons of the Danish mortgage model**

**IV. Conclusion: Financial inclusion beyond access to mortgages**

# A family's story: key steps to obtaining a mortgage in Denmark

After a long search, a young Danish family has finally found the house of their dreams. As most Danish households, the family will ask for a mortgage loan in one of the Danish mortgage banks, specialized in mortgage lending at specific conditions.

## STEP 1: **Credit worthiness check**

First, certain conditions will need to be met by the family: a standard creditworthiness process will be carried out, checking the family's ability to repay. This includes the yearly tax form that all Danes receive each year, stating income as well as registered debt and saving, the past three months pay slips, and information about their pension plan. Meanwhile, the family must also provide a customized budget combining past spending and expected future expenses in regards to the new house. All data and information provided by the family is measured up against guidelines on minimum requirements for disposable income after fixed costs from relevant authorities.

## STEP 2: **Assessment of market value of property**

Since the mortgage bank is lending against the value of the brick, it has to make an assessment of the market value of the property in order to establish the maximum loan amount that the mortgage bank can pay out on the relevant property. The evaluation incorporates the marketability of the property, establishing whether a market for a resale in fact exists. If the assessment finds that no market exists in the specific location or for the specific property the mortgage bank might in fact be prevented from lending. The principles behind both credit check and evaluation are set out within the tight legislation on mortgage lending in Denmark.

## STEP 3: **Savings: mix of universal and mortgage bank needed**

The mortgage bank can lend up to 80% of the total market value of the property so the family has to either have savings equivalent to 20% of the value of the property, or take out a loan from a universal bank, up to a maximum of 15% of the value of the property. It is a legal requirement that the family must provide a down payment of at least 5% of the value of the property in order to get both a loan from the mortgage bank (80% of the value) and a universal bank (the remaining 15%, if necessary).

## STEP 4: **All conditions met: the loan is granted at equally low standard interest rates for all**

If the family meets all these conditions, the mortgage bank will grant a mortgage loan at standard conditions, which are the same for all borrowers – no individual risk based pricing, something quite unique! The interest rate is among the lowest, if not the lowest, on the European market. This is achieved thanks to the mortgage bank's unique functioning. Contrary to universal banks, the loan is not generated via debt creation, but by collecting money from investors on the financial markets. All in all, it resembles a system of "crowd-lending" but very much institutionalized and with specific safety mechanisms to ensure maximum guarantees for the investors.

## STEP 5: **The mortgage bank issues a covered bond: the balancing principle**

Once the mortgage for the family is approved, the mortgage bank issues covered bonds with specific conditions that will be sold on the financial markets. The money collected will fund the mortgage loan. The investors that decide to buy the covered bonds will receive the equivalent of the family's monthly repayment of capital and interest – this is referred to as pass through or the balancing principle. Additionally, the family pays origination commissions when the loan is originated and subsequently a transparent fee to the mortgage bank to cover such costs as administration, hedging risk in case of defaults/problems and servicing capital.

## STEP 6: **Ready to go, with a welfare/housing safety net along the life course**

During the life course of the mortgage, many things can happen. The family must take good care of their property. If they fail to do so, the mortgage bank can terminate the loan and engage a procedure of foreclosure of the property (since the loan is guaranteed against the value of the brick). If the family experiences major (financial) problems, the Danish social safety net provides them with unemployment benefits and other financial support which can help them meet their financial obligations (including paying back the mortgage loan). In case of a default on the mortgage loan, a swift foreclosure procedure allows the mortgage bank to sell the property. This is made possible thanks to the Danish social housing system, which ensures that the family will not be forced out of their home and end up homeless. These elements are essential to the Danish mortgage system, and are part of the reason that it can lend at such low interest rates and at standard conditions for all borrowers, as well as ensuring that investors are well protected.

## STEP 7: **Early Redemption for consumers**

Finally, if during the life course of the mortgage, market conditions get better and the interest rates fall, the family can enjoy an "early redemption" of their mortgage at market conditions. What this means, is that the family can simply ask for another mortgage credit with the new advantageous market conditions and buy the equivalent in covered bonds of the outstanding debt of their previous loan, which will "cancel out" the debt!

# History and foundations of the model: legal, welfare and housing context

## A brief history

The Danish Mortgage model was born out of the ashes of the 1795 Copenhagen fire, which destroyed a quarter of the entire city. In order to fund the reconstruction of Copenhagen, a group of lenders formed in 1797 the first Danish "mortgage bank", whose activities were limited to Copenhagen.

The Danish mortgage lending model further consolidated after the Danish constitutional reform of 1849 which allowed the formation of unions. Thus the mortgage lending model became a cooperative, serving its members (borrowers). The down side of the model was that its lending policy was very conservative. Borrowers which had their needs met (had access to a mortgage loan) were less inclined to allow higher risk borrowers access to a mortgage.

After World War II, the model evolved further by enlarging the pool of borrowers to all Danish borrowers (not just members of the cooperative) and reallocating the distribution of profits of the mortgage lending activity away from the members of the cooperative.

## The overall Danish context

The Danish mortgage model is grounded deeply in the broader context of the Danish social welfare system. This is not to be underestimated when considering transferring such a model to other countries, or even learning from such a model.

There are two main components of the social welfare system which play a key role.  The first one is the eligibility to unemployment benefits and support in finding employment (training etc). This prevents many borrowers from defaulting on a mortgage loan in the first place, and avoid undergoing a foreclosure. The second one is a social housing policy which provides certain guarantees against finding yourself on the streets, which allows a swift foreclosure policy in case of default, something very hard to implement in other countries where borrowers are protected against evictions if they have no other place to live.

## Core principles and functioning of the Danish mortgage model

### Principle 1: **Value of the brick**

- Any lending is done against the "brick value" of the property. In other words, lenders have access to collateral in case of default on the part of the borrower.

### Principle 2: **Covered bonds and the balancing principle**

- Financing of the loans is done via issuance of covered bonds. This means that there is no "money creation" and no leverage as in universal banks. The mortgage banks serve as an intermediary between financial investors who buy the covered bonds and the borrower (who receives the money generated from the sales of the covered bonds in the form of a mortgage loan). This is part of the balancing principle, which makes it clear how the cash flows generated from the loan are allocated (paid out to the investor via interest rates matching or used to cover risk or fees of the mortgage bank) and eliminates market risk for the mortgage bank. Indeed, the market risk (for instance, in case of interest rates fluctuations) is borne by the bond investor and the borrower.

### Principle 3: **Shared liability**

- Loans are issued with joint liability, meaning that both the borrower and the mortgage bank are liable to repay the loan to the investor. This ensures more prudent lending.

## Principle 4: **Protection of the borrower**

- The loan to private households cannot be terminated by the lender. This means that the lender can only terminate the loan under very specific conditions, which protect the borrower. As long as the borrower maintains his/her house in a proper way and pays the instalments, the mortgage bank cannot call the loan.

## Principle 5: **Prudent lending and risk management**

- The mortgage loans are "originate to hold', which means that banks cannot take them off their books, they cannot be sold to a third party, and thus, there can be no risk transfer, which further ensures responsible lending.

## Principle 6: **Transparent pricing and policy**

- The pricing of the mortgage loans is highly transparent, with a clear breakdown of the interest rate into its components (the part going to the covered bond holder, the part covering the fees/commissions, the part covering the risk). Borrowers can even check the current price of mortgage loans by checking them online, since they depend mostly on market conditions (interest rates levels).

## Principle 7: **Swift foreclosure**

- In case of default on a mortgage loan, the Danish mortgage model relies on a very swift foreclosure process which takes between 6 to 12 months, allowing the bank to get access to the collateral (selling the property) thereby ensuring an uninterrupted cash flow for the covered bonds.

# Regulation: The legal context

The Danish mortgage model is heavily regulated to preserve its core principles and ensure its continued stability.
Danish mortgage banks have to limit their lending to 80% of the loan-to-value of the real estate property for private loans (at maximum, the loan amount cannot exceed 80% of the value of the property) and 60% for business loans. The evaluation of the value of the property is also subject to regulatory requirements laid down by the Danish Financial Supervisory Authority (FSA).

The funding for the loans issued by Danish mortgage banks can only come from covered bonds (no leverage) and the balancing principle, discussed above, is also a legal obligation. In case of default, covered bond holders have a preferential status in the event of a bankruptcy.

Danish mortgage banks are subject to standard responsible lending legal requirements.

# PROS AND CONS OF THE DANISH MORTGAGE MODEL

## Advantages and benefits of the model

Some of the advantages are directly derived from its core principles above: high product/pricing transparency, lower risk overall (no leverage and monetary creation, joint liability…) and borrower protection against loan termination.

Other advantages include:

- A market-based prepayment system which allows any borrower to repurchase their loan at market conditions. Any borrower can purchase, on the financial markets, the equivalent in covered bonds of his/her outstanding debt and thereby terminate the loan. This is particularly useful in case market conditions have improved and interest rates are lower.
- All creditworthy Danish households have access to a very cheap mortgage loan at a single common interest rate.
- The Danish population can directly benefit from such a system by also investing in covered bonds. For instance, many Danish pension funds invest in these covered bonds, thereby ensuring a certain "circular" economy where Danes can be simultaneously borrowers and investors.
- The underlying financial product, the covered bonds, proved to be exceptionally resilient to the financial crisis, which is a token of their robustness. This resilience also allowed Danish mortgage banks to lend even during the crisis to both households and businesses, keeping the economy irrigated, at times when universal banks experienced a contraction in credit issuance (a credit crunch).

## Limitations, existing and future challenges of the Danish mortgage model

Although the Danish mortgage model has many advantages and benefits, there are nonetheless a number of limitations and challenges.

- European regulatory requirements may put the model under severe strain, if the regulation does not take into account the specificities of the model. For instance, subjecting the Danish mortgage banks to the same capital requirements as other universal banks could severely harm the model.
- Even though Danish mortgage banks are lending in all parts of Denmark, Danes are not guaranteed a mortgage loan. Since the model relies on the "value of the brick" as a form of guarantee of the loan (collateral), borrowers wishing to purchase a home in rural areas where housing prices are either declining or are at a risk of declining will not necessarily be able to get a mortgage from Danish mortgage banks.
- While the model currently offers very favorable conditions, this could change in the future. For instance, there is no regulation or other requirement forcing mortgage banks to propose a unique interest rate to all borrowers, and so individual risk based pricing could be introduced. Also, while the fees and commissions that the mortgage banks take are currently low, there is no guarantee that they will stay low in the foreseeable future, notably because many mortgage banks have now been integrated as a branch of universal banks within Denmark. These universal banks could decide to raise fees and commissions to increase their profits.

# Conclusion: Financial inclusion beyond access to mortgages

While the Danish mortgage model does provide a simple financial product at unbeatable conditions, as we have seen above, it is not suited for any borrower. A number of criteria need to be met in order to access the mortgage loans, which is understandable in terms of responsible lending and borrowing.

The definition of financial inclusion from Investopedia reads as follows: "The pursuit of making financial services accessible at affordable costs to all individuals and businesses, irrespective of net worth and size respectively. Financial inclusion strives to address and proffer solutions to the constraints that exclude people from participating in the financial sector."

Even though Danish mortgage banks have a broad reach in the Danish economy standing behind two thirds of loans in Denmark, the Danish mortgage model does not fit within this definition. This is by no means a critique or a weakness of the model, but simply that it is not suited for certain categories of individuals (for instance, poor people with insufficient financial resources) and for good reasons (prevention of over-indebtedness, responsible lending). It also does not diminish in any way the larger benefits that eligible Danish households derive from such a model, namely, extremely low interest rates, simple and transparent product/conditions, early redemption possibility, and more.

Nonetheless, every individual, regardless of his/her financial resources, has certain needs which requires access to certain financial products/services. As we have seen above, the Danish mortgage model has to be assessed in the broader Danish context. Individuals which are not eligible for a mortgage loan have access to other possibilities for meeting certain essential needs such as housing via the Danish social housing system – a system that is also funded by mortgage banks through the issuance of covered bonds guaranteed by the Danish state. So while not every single Dane can benefit directly from the advantageous conditions of the Danish mortgage model, there are specific fallbacks and alternative options for those individuals, ensuring that they have access to housing at a decent cost.

The broader question that finds no obvious answer is: should all individuals aspire to home ownership? Or in other words: is home ownership the right "solution" for all individuals, regardless of their financial resources?

Indeed, renting (including renting social housing) may be more suitable for low income households or households which are ineligible for a loan.

One possible improvement for the future is to envisage multiple solutions for households ineligible for a mortgage loan from a Danish mortgage bank. For instance, the Walloon Housing Fund in Belgium provides mortgage loans for vulnerable households which would struggle to find a mortgage from "traditional" lenders (universal banks). Such a service is possible thanks to public subsidies and thus is an alternative to publicly funded social housing, further expanding the choice for households in financial difficulty, allowing them to choose between renting or home ownership.

# FAQ

## What is the difference between a universal bank and a Danish mortgage bank?

A mortgage bank in Denmark operates very differently from a universal bank. The biggest difference is that universal banks are allowed to “create” money in the form of credit depending on the amount of money they hold (money reserves) while Danish mortgage banks finance themselves directly on the financial markets, which means they cannot “create” money. They are only a third party between borrowers and investors (people buying covered bonds on the financial markets), which keeps part of the loan instalments to finance its operations and cover the risks of default.

## What is a covered bond?

They are a financial product that investors can buy on the financial market that has a certain cash flow associated with it (in this case, the instalments paid by borrowers) and which is secured by the value of an asset (in case of default of the borrower, in this case, the home).

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