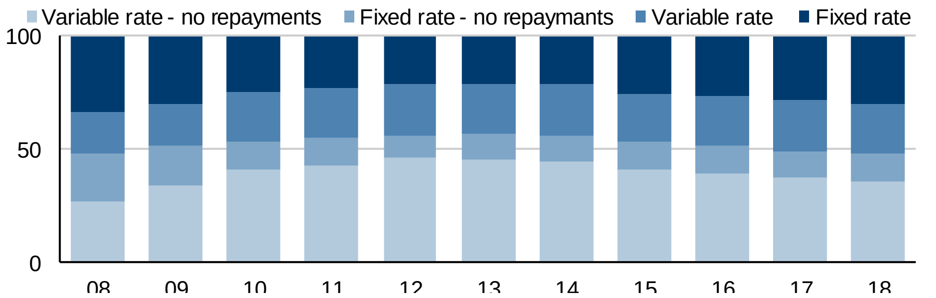
Lower refinancing risk in Danish mortgage loans but no room for complacency

Macroprudential measures introduced to cushion against the impacts of the shifting monetary cycle and other structural factors have led to credit-positive shifts in Danish residential mortgage loans. But there is still a significant risk cluster where households are exposed to interest-rate and refinancing risk.

Dealing with the latent risk exposures of residential borrowers with interest-only and/or short interest-reset mortgages in a rising rate cycle created the basis for a series of changes to mortgage lending guidelines (see Table 1 on page 2). These included caps on interest-only and short interest-reset borrowing by highly leveraged households as well as LTV ceilings, to provide a foil against rising rates and other structural sensitivities.

These measures have gone some way to mitigating interest-rate and refinancing risk for new loans. "When it comes to the structure of mortgage exposures, the overall picture looks better today than five years ago. An increasing proportion of outstanding loans are in instalment format, which is a positive sign. But, if you look at the interest-only bucket, which is still roughly 50% of the total, around three-quarters are in variable-rate format. That is a significant risk cluster," cautions Mathias Pleissner, associate director in the covered bonds team at Scope Ratings.

Figure 1: Repayment and interest rate type in Denmark

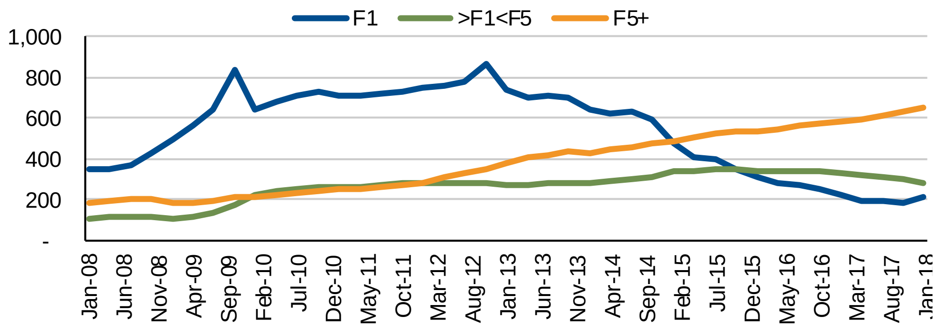


Source: Danmarks Nationalbank

Short interest-reset mortgages have reduced significantly in the past decade (See Figure 1) and are now below 2008 levels. The trend towards short-term interest-rate periods in the 2010-2013 period was driven less by the low interest-rate environment; more by the need to enhance affordability during and after the 2008 financial crisis, which created an environment of stressed market values, low GDP growth and rising unemployment.

Loans with reset periods up to one year (F1) have come down significantly (see Figure 2). From an affordability perspective, F1 loans still have the lowest rates. Better relative affordability accounts for some of the shift to longer resets but more importantly, absolute rate levels have come down significantly (see Figure 3) since 2012, making such loans more attractive. This is likely to be a reason for stronger demand in recent years.

Figure 2: Outstanding amount, split on reset cycle (DKK bn)



Source: Danmarks Nationalbank

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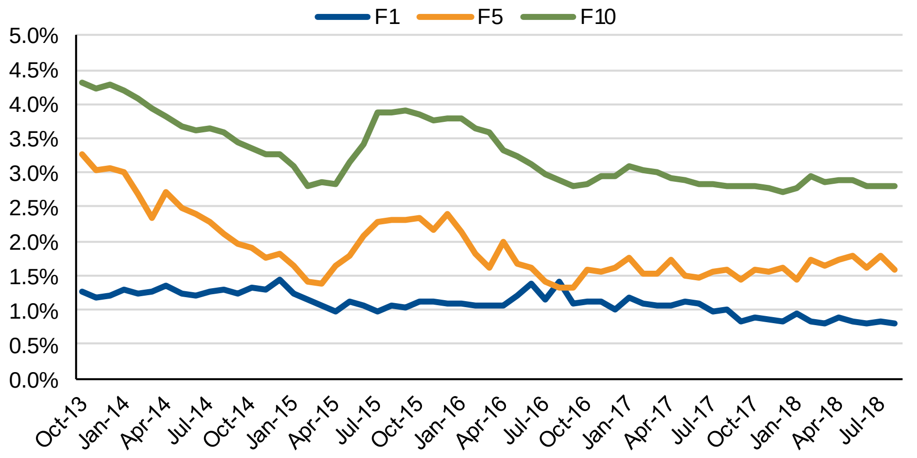
Table 1: Macroprudential Measures Denmark

Jun 10	Supervisory Diamond limiting, among other things, liquidity and funding risk for commercial banks
Nov 15	Homebuyers required to make at least 5% down-payment
Feb 16	Guidelines for cautioned lending; 7 best practices including loan-to-income rule ensuring financings can withstand price declines of up to 25%
Jan 18	For home-owner loans with debt-to-income > 4x and LTV > 60%: Interest fixing at least 5y and deferred amortization on 30y fixed rate loans only
Jan 18	Supervisory Diamond limiting, among other things, interest-only and variable rate lending if LTV > 60% to max 15% of lending growth

A 10-year interest-reset loan from a mortgage bank in 2013 cost 4.3% on average. Today it is 2.8%. The same trend can be observed with reset loans at five years and above. Over the same period, the decline in F1 interest rates has been marginal despite a significant reduction in the Danish interbank reference rate. “The add-on premium that households have to pay to enter into a 10-year fixed-rate loan contract over short-term adjustable-rate mortgages is decreasing. On a relative basis, it’s much cheaper today to enter into a long-term interest-rate loan than it was in the past,” Pleissner notes.

Figure 3: Avg. loan interest rates, new domestic mortgage loans



Source: Danmarks Nationalbank

The trend to a lower share of loans with short reset cycles towards longer fixed-rate periods has gathered momentum since 2013 partially as a consequence of improving economics and stronger affordability. But it has also been a consequence of banks increasing margins on loans with short interest resets (specifically F1 loans) and on interest-only loans between 2012 and 2017 to switch customers into loans less exposed to interest-rate risks (itself an outcome of supervisory guidance).

The overall trend to loans with less exposure to interest-rate reset risk is credit positive from the perspective of the performance of the individual mortgage loans, but fixed-rate loans today are still not back at the levels seen in 2008. Banks have 36% of non-amortising variable-rate loans in their mortgage portfolios. This may be below levels seen in recent years, but it remains at a relatively elevated level.

On average, the reset cycle has been relatively stable since 2013 with variable loans accounting for around 50%. And despite the macroprudential measures in place limiting the amount of interest-only loans, the decline observed in recent years is slowing. “We do not believe the shift in portfolio composition will continue despite the low interest-rate environment. The share of floating non-repaying loans will remain notable because the macroprudential measures in place do not ban, but merely limit such exposures,” says Pleissner.

In the past, neither variable loans nor interest-only loans have shown significantly higher default behaviour in Denmark compared to fixed and amortising loans. That may be driven by prudent underwriting criteria for such loans, but interest-only and short reset loans are more exposed to extreme scenarios.

In a stressed environment where borrowers suffer a decline in property values and at a time when interest rates are rising, refinancing will be difficult. First, because of the lower affordability assuming higher interest rates; second because of higher leverage caused by market values going down. Both could be mitigated if the interest period is longer and the loan amortises. In this scenario, interest-rate shocks would not immediately hit the borrower's affordability, and amortisation would temporarily buffer market-value fluctuations.

In our analysis of Danish covered bonds secured by residential mortgage loans, we have addressed refinancing risk by increasing default volatility, which increases the weight of scenarios with a large proportion of defaults.

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