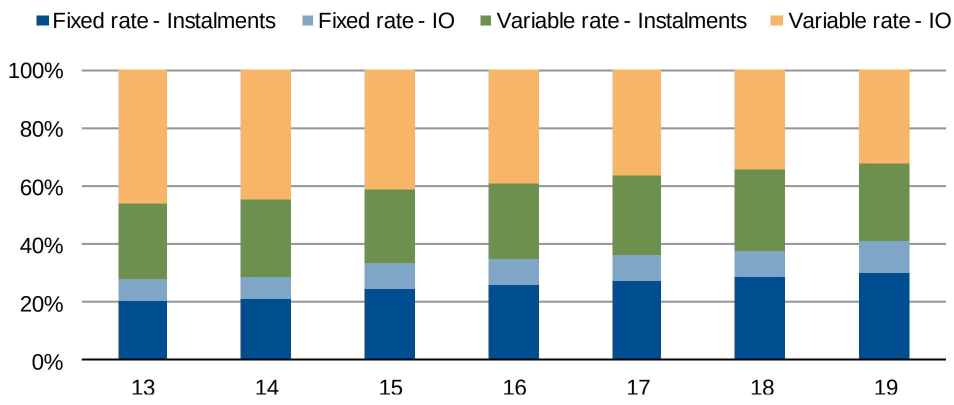
Phase 2 of the Supervisory Diamond will increase resilience of Danish homeowners

Stricter underwriting standards for interest-only and variable-rate mortgages will further increase the resilience of Danish homeowners and improve financial stability. This results from the activation in January of phase 2 of the Danish Financial Supervisory Authority's (FSA) "Supervisory Diamond". Phase 1, coupled with the low interest-environment, had already helped to assuage concerns about the domestic residential mortgage sector. As there is still a significant risk cluster from households exposed to interest-rate and refinancing risk, however, we see the further tightening as credit positive.

2019 marked another record year for refinancing in Denmark: about 80% of 'new' mortgages were refinancings of higher-yielding mortgages. Most borrowers choose fixed-rate loans allowing them to lock in low interest rates for longer. With Phase 2 of the supervisory diamond activated, we expect the share of interest-only loans with higher refinancing risk to further reduce. Fixed-rate and amortising loans are not back at the levels seen in 2008 but at the end of 2019, Danish mortgage banks still had 32% of non-amortising interest-only variable-rate loans in their portfolios. Even if this is below levels seen in recent years, it remains elevated.

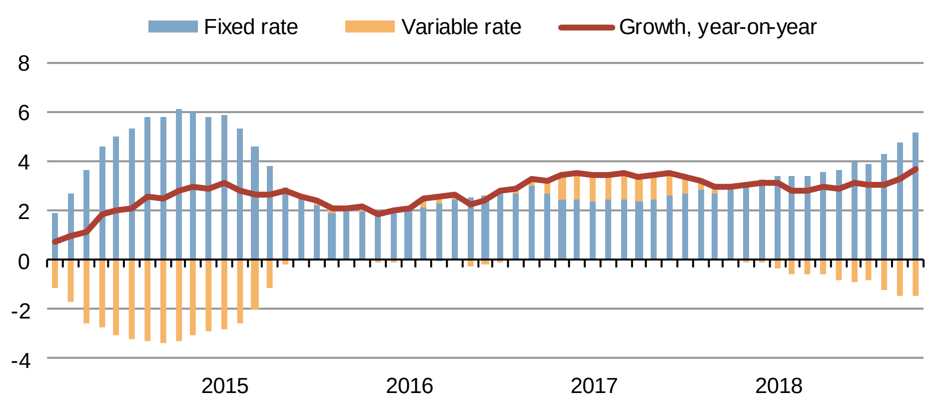
Figure 1: Repayment and interest rate type in Danish mortgage books



Source: Danmarks Nationalbank. Scope Ratings

Also, thanks to phase 1 of the Supervisory Diamond, loans with reset periods of up to one year have come down significantly – to 30% in 2019 from 47% in 2013. Growth in mortgage lending in recent years has almost completely been down to fixed-rate mortgages.

Figure 2: Mortgage lending growth contribution (in %)



Source: Danmarks Nationalbank. Scope Ratings

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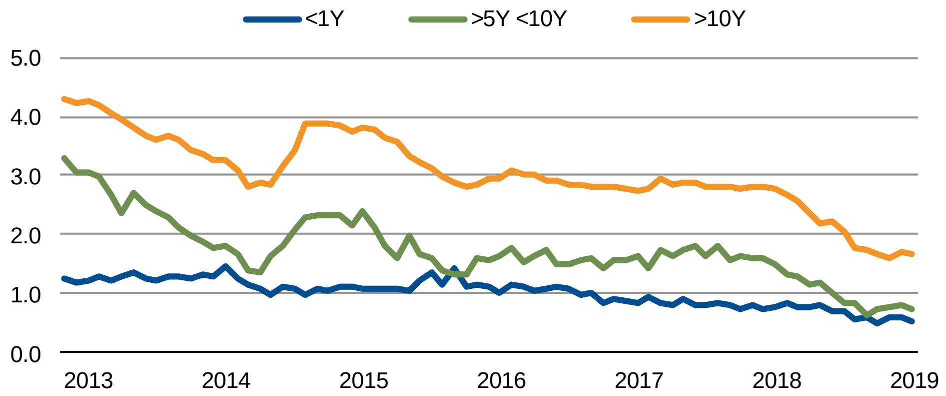
Phase 2 of the Supervisory Diamond will increase resilience of Danish homeowners

Low interest rate environment makes fixed rates more attractive …

Longer fixed-rate periods more attractive today

Taking out a fixed-rate loan in Denmark no longer penalises borrowers. A variable-rate mortgage today costs almost as much as a five to 10-year fixed-rate mortgage. This compares to a yield difference of about 2% in 2013. In August 2019, Jyske Bank even introduced a -0.50% 10-year fixed-rate mortgage for prime customers (see Danish negative-rate loans more a marketing tool than a market mover). Teaser products like this are not available for all borrowers but the premium for a fixing of 10-years or more has compressed significantly. On average, longer-term fixings have declined to 1.7% from 4.3% and the cost for long-term affordability reduced to 1.2%.

Figure 3: Average loan interest rates, new domestic mortgage loans (in %)



Source: Danmarks Nationalbank. Scope Ratings

More refinancings are yet to come

The unique Danish mortgage system gives borrowers the opportunity to pre-pay outstanding mortgages at par and refinance at a lower rate. Many Danish households have already benefited from lower interest rates by restructuring their old mortgages. According to Finance Denmark, however, there are still more than 325,000 mortgages with an interest rate of 2% or above. With the current interest-rate environment, this means that the refinancing trend is not likely to cease any time soon.

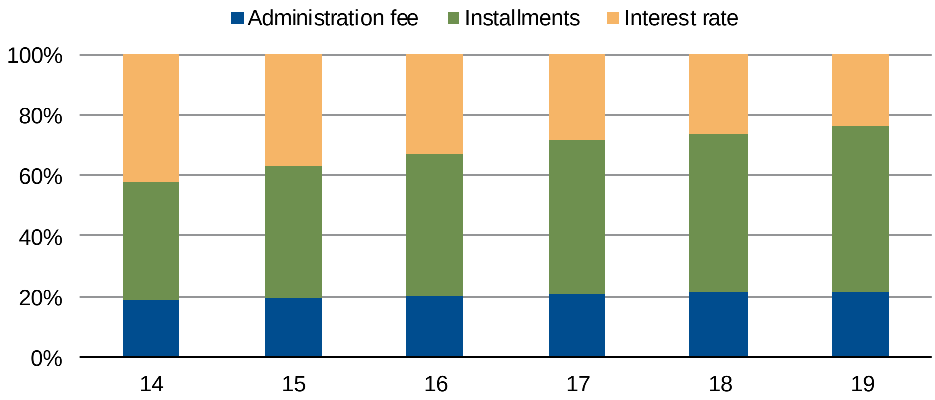
Lower absolute and fixed rates mean higher affordability for borrowers. But, having a fixed-rate mortgage can provide additional windfall profits – when interest rates eventually increase again. The matched-funding principle in Denmark requires that every mortgage loan is refinanced by a corresponding mortgage bond. A borrower with a fixed-rate loan could call its mortgage by buying this very same mortgage bond at market price. A rise in interest rates would push this bond significantly below par and borrowers could use the difference to further reduce their debt burden.

… and gives households the ability to amortise their debt faster

Interest savings used to increase amortisation

Another positive result of the low interest-rate environment is the faster principal repayment of mortgage debt. Between 2014 and 2019 the average interest rate of Danish households decreased by 90bp. Of that, 60bp was used for increasing instalment rates. Together with the decreased share of interest-only loans, to 42% in 2019 from 53% in 2013, the nominal amortisation rate is now at a level not seen since 2005.

Figure 4: Breakdown of mortgage payments rates



Source: Danmarks Nationalbank. Scope Ratings

Household indebtedness still high, but decreasing

Danish household indebtedness still stands out, with an income multiplier of 2.8x (although this is down from its peak of 3.4 in 2008/09). As we pointed out, this is a key risk factor for the housing sector (see High household debt in the Nordics a key vulnerability?). However, the deleveraging process is fully underway, and we think that authorities are taking the right steps to maintain the current momentum.

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.; Seven best practices including loan -to-income rule ensuring financings can withstand price declines of up to 25%
Jan 18	For homeowner loans with debt-to-income of >4x and LTV >60%: Interest fix at least five years and deferred amortisation on 30-year fixed rate loans only
Jan 18	Phase 1 Supervisory Diamond Limiting overall lending growth to 15% and variable rate lending if LTV > 75%
Jan 20	Phase 2 Supervisory Diamond Share of interest-only loans with LTVs above 75% is limited to 10% of the total loan portfolio. Proportion of mortgage bonds auctioned must be below 12.5% within a quarter and below 25% within a year.

Macroprudential measures introduce further restrictions …

The final two measures of the Danish Supervisory Diamond for mortgage banks were phased in in January, further tackling refinancing and interest-rate risk. The first measure limits the share of interest-only loans with an LTV above 75% to 10% of a bank's mortgage portfolio, while the second targets mortgage banks' refinancing risk.

We have acknowledged the positive impact from previous macroprudential measures, especially with regard to the riskiest borrowers. In 2017, a high proportion (42%) of new mortgage lending to first-time buyers with elevated debt-to-income and loan-to-value levels in the Copenhagen area were predominantly variable-rate, interest-only loans. This reduced to 22% in 2018 while at the same time the share of fixed-rate amortising loans increased from 27% to 40%.

… creating an additional buffer for the worst case

Neither variable-rate nor interest-only loans in Danish portfolios have shown significant higher default behaviour in Denmark compared to fixed-rate and amortising loans. While this might reflect more prudent underwriting criteria for such loans, interest-only and short-reset loans can exhibit higher credit risk in extreme scenarios.

Refinancing mortgages will be difficult in a stressed environment if a slump in property values pushes up LTVs, and borrower affordability is stretched because of a higher interest-rate environment. Both of these can be mitigated if the interest period is longer and the loan amortises. In this scenario, interest-rate shocks would not immediately hit affordability while ongoing amortisation can shield borrowers against a slump in house prices.

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