DET SYSTEMISKE
RISIKORÅD

30 September 2014

Recommendation

Restriction of deferred amortisation on mortgage loans

The Systemic Risk Council (the Council) recommends that the government ensures that a restriction is imposed on the mortgage banks' mortgage loans with deferred amortisation at high loan-to-value, LTV, ratios. Such a restriction will reduce the credit risk for mortgage banks and thus contribute to preserving the high degree of confidence in and the robustness of Danish mortgage bonds. The Danish Financial Supervisory Authority has published a proposal for a Supervisory Diamond for mortgage banks. All members of the Council finds that it is a good initiative to establish a Supervisory Diamond for the mortgage banks as is already known from the existing Supervisory Diamond for banks. The diamond for mortgage banks suggests restrictions on deferred amortisation loans.

The Council recommends that the Supervisory Diamond should be supplemented with legislation on lower borrowing limits for deferred amortisation loans as a ratio of the property value at the time of granting the loan.

A statement by the representatives of the economic ministries is given below. The government is required, within a period of three months, to either comply with the recommendation or to present a statement explaining why the recommendation has not been complied with.

Explanatory statement

The increased flexibility of financial planning associated with deferred amortisation loans entails welfare gains. Examples are servicing of more expensive debt first and the possibility of optimising consumption over time.

On the other hand, deferred amortisation increases the credit risk for mortgage banks if households do not use it for other consolidation purposes, and it may also have a contagion effect on the risk for banks. This is partly due to the structure of the financial system, whereby banks are granting home loans on the basis of the topmost collateral, and partly due to the interconnectedness between banks and mortgage banks. Examples of the latter are bank guarantees of parts of mortgage banks' lending and the banks' portfolios of mortgage bonds. Moreover, a study shows that the loan impairment charge ratio for owner-occupied homes is higher for high LTV ratios.

At the same time, deferred amortisation combined with the current very low level of interest rates makes it possible to accumulate high debt and still pay low instalments. This may induce bubbles and lower macroeconomic demand in a future situation with higher interest rates.

Mortgage banks are dependent upon being able to issue bonds in their role as intermediaries between investors and borrowers. The ability to issue bonds depends on the existence of a well-functioning market and on confidence in the individual mortgage bank and the mortgage credit system as a whole. Hence, it is important that the mortgage banks opt for a prudent business model with a suitable margin to the statutory limits, to the benefit of investor confidence and financial stability. Higher amortisation is found to further strengthen confidence in and the robustness of the Danish mortgage-credit model.

In its own right, but also via the high degree of interconnectedness with the banking sector, the robustness of the mortgage credit system plays a crucial role in financial stability.

Even small instalments may influence the level of mortgage banks' losses on lending at high LTV ratios, since the losses concern the last kroner. And even small losses may have a strong impact on the institutions' capitalisation, since the generally high degree of security in the system is reflected in low risk weights and thus substantial leverage. In addition, the requirement for top-up collateral is reduced. A reduction of the access to deferred amortisation at high LTV ratios can thus contribute to protecting the high degree of confidence in Danish mortgage bonds.

In 2013, approximately one third of total new lending by mortgage banks for owner-occupied homes were deferred amortisation loans with LTV ratios of 60-80 per cent. This applied both in structurally challenged municipalities and in the rest of Denmark. The share of deferred amortisation loans out of new lending in the LTV interval of 60-80 per cent decreased from 2008 to 2013, and the share of deferred amortisation loans was slightly lower for structurally challenged municipalities than for the rest of Denmark.

The timing of a structural adjustment is good, given the low level of interest rates, which poses a risk of excessive indebtedness. However, it must be phased in smoothly. Restriction of access to deferred amortisation is assessed to have a possible dampening effect on the growth rate of house prices via the effect on first-year payments. This possible effect is found to be limited, inter alia because new home buyers must already be able to afford a fixed-rate loan with amortisation.

Lars Rohde, Chairman of the Systemic Risk Council

Statement from the representatives of the ministries on the Council

The legislation regarding the Systemic Risk Council stipulates that recommendations addressed to the government must include a statement from the representatives of the ministries on the Council.[1] Neither the representatives of the ministries nor the Danish Financial Supervisory Authority have the right to vote on recommendations addressed to the government.

The representatives of the ministries agree that there is a need to reduce the mortgage banks' risks linked to the volume of deferred amortisation loans at high LTV ratios, but emphasise that such reduction should be effected in a balanced manner, taking both financial stability and the current situation in the housing market into account.

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1 The Ministries of Business and Growth, Finance, and Economic Affairs and the Interior are represented on the Council.

The representatives of the ministries support the Danish Financial Supervisory Authority's proposal for a Supervisory Diamond that includes an indicator for deferred amortisation. The indicator says that a mortgage bank's deferred amortisation loans must not exceed 55 per cent of the lending volume in the LTV band above 75 per cent of the LTV limit. Today, this proportion is 66 per cent.

The representatives of the ministries share the Danish Financial Supervisory Authority's view that the Supervisory Diamond's indicator for deferred amortisation will reduce the risk on deferred amortisation loans in a balanced manner and find that the Danish Financial Supervisory Authority's Supervisory Diamond addresses the current risks in a more expedient way than a fixed lower limit for deferred amortisation would do. The Supervisory Diamond's indicator for deferred amortisation still leaves room for many families to plan their finances so that e.g. expensive bank loans are repaid before the less expensive mortgage loans.

Overall, the representatives of the ministries find that the Danish Financial Supervisory Authority's proposal for an indicator for deferred amortisation as part of the Supervisory Diamond – in conjunction with the government's proposal that buyers must provide a 5 per cent down payment when purchasing a home – will reduce the current risks linked to households' home financing in an appropriate way. Combined with the enhanced capital and liquidity requirements adopted as part of Bank Rescue Package 6, these initiatives will help to safeguard the high degree of confidence in and the robustness of Danish mortgage bonds.