Mortgage Finance and Security of Collateral

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This paper sets out to discuss the interference between mortgage finance and collateral security by using the Danish mortgage financing model as an example, because it exposes the naked relation between credit risk and mortgage finance. Moreover, the Danish mortgage finance system opens for a discussion of the role of security of collateral in a development perspective through its 200 years long history.

The financing model is still of high actuality due to its comparative advantage with other financing systems as documented in international studies. The system is recommended both as an option in emerging markets (UN-ECE 2005) and as a possible model for remedying failures in mature housing finance markets.

The real sector and the capital market differ fundamentally in mature and underdeveloped credit markets. Developing economies face a gigantic lack of financing for urbanization due to the absence of formal and transparent property markets. It is suggested that development policies in land administration need to be revised in order to support a widening of credit markets and effectively serve pro-poor policies.

Danish Mortgage Finance in brief

A presentation of the Danish Mortgage Finance system will always include a reference to its 200-year long history (Haldorup-Tvedt, 2010). The Danish mortgage finance model is based on the balance principle that originated from Germany, and was first applied in Copenhagen in 1797.

The society went through a transition from a largely subsistence based agrarian economy in the beginning of 19th century towards specialization, urbanization and a money economy leading to an increasing demand for credit in the latter part of the century. As soon as the first mortgage credit act was passed in 1850, mortgage credit associations spread fast across the country prior to the existence of local banks.

Mortgage Credit associations were originally formed as democratically organized associations with borrowers as members and owners. The underlying principle of potential borrowers was entirely based on assessment of the property value, not on underwriting of the applicants’ ‘bankability’. Hence, the system opened the way for entrepreneurship individuals to work their way to prosperity irrespective of their background. Collateral security served as a sufficient guarantee for the credit. The solidarity clause was rarely invoked but impacted on the practices of associations, and strengthened trust in the system.

Mortgage financing through mortgage credit associations grew steadily by the end of the 19th century to reach a high level of outstanding credit already prior to WWI. The system has continued to supply credit to different sectors of society although residential credit is now dominating the market. The total volume of the mortgage market in Denmark currently exceeds GDP.

Financial sector reforms took place in the latter part of the 20th century upon entering the European community. Mortgage credit associations were consolidated in the 1970’s and restructuring continued after 1983 as new legislation opened for a conversion of mortgage credit associations to shareholder companies. The core of the mortgage finance system, securitization based on the balance principle, has stayed intact until adjusted due to EU regulations in 2007 (Haldorup, 2011).

Performance during crisis

Several bubbles and bust in the property market and economic crisis have brought mortgage finance systems to a test. Changes in mortgage finance legislation may also exert a strong influence on the market, and even contribute to bubbles and busts in the housing market. The relation between mortgage finance, the real sector and the macro-economy has demonstrated its awesome power during the global financial crisis ignited in 2007 by the sub-prime crisis in the US, but not all markets have been hit in the same way. Each severe crisis has given reason to re-examine the Danish mortgage credit system, as was the case during the crisis in the 1930’s resulting in intermediate crisis legislation and an overhaul of the mortgage credit act. Borrowers and investors suffered, but the losses of mortgage credit associations were relatively low.

Even when the global financial crisis in September 2008 stopped the issue of real credit in many other countries, Danish Mortgage Banks continued issuing credit and bonds. Danish covered bonds were safe and liquid investments even during the most severe phase of the crisis. However, crisis legislation supported the system indirectly on the side of institutional investors. In the wake of every major crisis has followed a scrutiny of the finance system and the market in order to identify the shortcomings of the system and suggest approaches to mitigating a future crisis. In this way every crisis has formed a learning lesson and triggered adjustments of legislation and practices.

The Mortgage Credit system escaped detrimental losses during periods of crises, but during booms and busts in the property market it was apparent that ‘valuation’ is the Achilles heel of mortgage finance. Valuation is not only a technicality, but predicting the future price development forms a challenge especially during a booming market.

The Balance Principle of Securitization

International studies point to the comparative advantage with other financing systems, but hereby it is also suggested that elements of solidarity coverage in the mortgage credit act. Borrowers and investors have access to early repayment of the loans and bonds, which ensure an alignment of risks and responsibilities. The simple and transparent funding mechanism reduces risks and overhead costs, and ensures a simple cash flow. Standardized loan conditions protect borrowers against predatory lending, while creating transparency in the market for borrowers and investors alike.

Loans are non-collateral by the lender, while borrowers have access to early repayment of the loan or refinancing by buying back the underlying bonds at their market rate. Borrowers are not locked in and can follow the market up and down, a feature that functions as a buffer and a safety valve.

Mortgage credit institutes are moral-economic businesses not permitted to engage in (other) banking or investment activities. Lending is regulated by stringent provisions on maximum LTV’s and consolidated appraisal rules, and capital requirement requirements, previously in mortgage associations also by elements of solidarity coverage.

The system is strictly regulated through the Mortgage Credit Act dedicated to protecting investors in mortgage securities, but hereby it is also serves the borrowers’ interests by attracting capital at lower cost.

Investors have a claim against the Mortgage Institute, covered by tiers of security in base capital and running costs of the issuer. In turn the Mortgage Credit Institutions have secured collateral in the pledged properties. Mortgage securities, also called covered bonds, have a status at the level of sovereign debt securities and are traded on the stock exchange. In this way the system has secured a huge flow of capital to the Danish society throughout its century long history.

In consequence the focus of risk analysis is on the lending institutions and their practices.

The Danish mortgage credit system performs well below average in terms mirroring the loan conditions. The proceeds of the sale of bonds determining the effective interest rate, which have always been determined by the market.

Specialized mortgage credit institutes, originally mortgage credit associations, act as market intermediaries that issue and stay responsible for the loans and bonds, which ensure an alignment of risks and responsibilities. The simple and transparent funding mechanism reduces risks and overhead costs, and ensures a simple cash flow. Standardized loan conditions protect borrowers against predatory lending, while creating transparency in the market for borrowers and investors alike.

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The system was fully market based, but embedded in a framework and supportive legal and administrative infrastructure in respect to the function within the capital market and the real property market.

Security of collateral rests on legal protection of pledges, clear property titles and associated services facilitating mortgage pledging, e.g., by keeping down transaction costs and risks. The property registration system is not only a precondition for the functioning of the mortgage finance system, but mortgage pledging has become the dominant form of transaction in the real estate market. The high level of remortgaging activities constitutes a lucrative source of public revenues. Indeed the total revenues of the registration activities exceed the running costs of the whole court system in Denmark (2008). Where these legal functions are in place, security of collateral is hinged on the factors determining collateral value, especially conservative valuation practices and prudent loan limits (Maximum Loan To Value, LTV) leaving a safety margin for future fluctuations in the market value.

A critical precondition for a functioning mortgaging market is effective foreclosure required for borrowers to call falls, in order to serve as part of a commitment mechanism for disciplining the mortgage market. Foreclosure has been effective in Denmark, since the mortgage bond market was first developed through the upper and middle market segments, a larger credit volume generated economy of scale, and investors’ trust in the system grew as reflected by better selling rates of the mortgage bonds in the capital market. Hence, the cost of credit was reduced and the upper market segments opened the way for credit to smaller properties.

Eventually this story is developing different forms of formal property markets and credit from the middle sector as an effective pro-poor strategy. Increasing volume provides economy of scale, lowering market risks reduce interest rates, and both factors contribute to lowering the cost of credit. It is therefore argued that democratization of credit goes through an expansion of the middle market segment, combined with legal safeguards and effective foreclosure. Topping a critical mass of properties in the upper and middle sectors could trigger positive dynamic flows to the benefit of the whole market.

A better understanding of the marginal dynamics of the combined factors of property rights security and mortgage finance could potentially lead to new strategies for meeting the gigantic need for housing credit around the world.

By: Karin Haldrup, Chartered Surveyor, PhD, Aalborg University

Framework Conditions and Security of Collateral

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