Mortgage Finance and Security of Collateral

Haldrup, Karin

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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 poor policies.

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

Danish Mortgage Finance in brief

A presentation of the Danish Mortgage Finance system will always include a reference to its 200-year-long history (Haldrup, 2010). The Danish mortgage finance model is based on the balance principle that originated from Germany, and was first applied in Copenhagen in 1790.

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 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 crisis, 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 the interest rate, which have always been determined by the market. Specialized mortgage credit institutions, 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.

Loans are non-callable 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 ‘valuation’ is the Achilles heel of mortgage finance. The system is strictly regulated through the Mortgage Credit Act. The Act protects investors in mortgage securities, thereby it is also serving investors’ interests by attracting capital at lower cost. Investors have a claim against the Mortgage Institute, covered by tiers of security in base capital and shares of the investor. In the 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.

Performance during crisis

Several bubbles and busts in the property market and economic crisis have brought mortgage finance systems to a test. Changes in mortgage finance legislation may also assert a strong influence on the market, and even contribute to booms 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 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.

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