FINANSTILSYNET

Mortgage credit institutions

Market developments in 2019

FINANSTILSYNET

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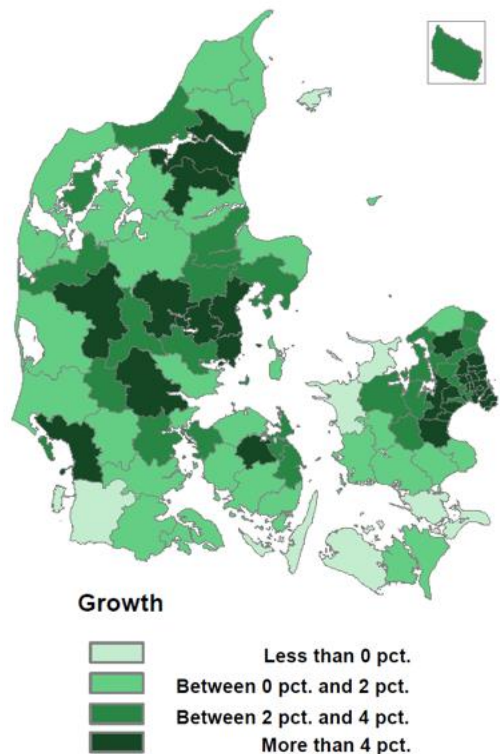
1. Summary

Mortgage credit institutions saw their total profits rise from DKK 18.5 billion in 2018 to DKK 21.7 billion in 2019, thereby achieving their highest level for the period 2007-2019. This rise is mainly attributable to higher value adjustments through capital gains on fund holdings. Mortgage credit lending grew 3.8 per cent in 2019, and positive lending growth for owner-occupied housing was widespread throughout the country, except for a few areas where the lending growth fell, see Figure 1.

Figure 1: Positive mortgage credit lending growth for owner-occupied housing in most of the country



Note: Mortgage credit lending growth for owner-occupied housing by municipality.
Source: Reports to the Danish FSA.

Short and long-term mortgage bond yields continued to decline in general in 2019. This resulted in a historically high remortgaging activity against low fixed interest rates. The long period of falling mortgage bond yields turned after the outbreak of COVID-19, which has led to economic and financial turmoil worldwide. The mortgage credit market experienced major declines in value during the week when the COVID-19 pandemic seriously impacted Denmark. This happened as part of a general movement across bond markets, including the safest government bonds, and not specifically for mortgage credit. In particular, it was long-term mortgage bonds which dropped in price. The values have partially readjusted and market participants are reporting the mortgage credit market's return to normal. Measured in relation to the government bond curve, long-term convertible mortgage bonds are trading at the same spread as in the autumn of 2019.

The low interest rate level in 2019 supported an overall rise in property prices, positive mortgage credit lending growth for most property categories and, along with the guidelines on risky loans, an increase in mortgage credit loans with instalments and fixed interest rates. If or when interest rates rise, this may have a downward effect on property prices, thereby dampening the mortgage credit institutions' future lending growth. In the event of interest rate increases, it is positive that many existing borrowers have secured fixed-rate loans so that their payments are not affected.

The economic and financial turmoil accompanying the current COVID-19 crisis is expected to primarily affect mortgage credit institutions' future earnings through a lower level of lending activities, value adjustments and increased loan impairments for the households and businesses which will be under pressure during and after the crisis. Impairments are expected, among other things, to rise for loans granted by mortgage credit institutions to office and business properties since business enterprises stand to be hit particularly hard by the crisis. On the other hand, interest rate fluctuations may lead to higher earnings for mortgage credit institutions as a result of higher remortgaging activity. The Danish mortgage credit sector is well-capitalised and well-equipped to withstand and absorb losses.

Mortgage credit institutions have been granted a temporary exemption from carrying out physical inspections of primarily residential properties as a result of the infection risk from COVID-19. This helps ensure that mortgage credit loans can continue to be granted through property sales and additional loans for these segments.

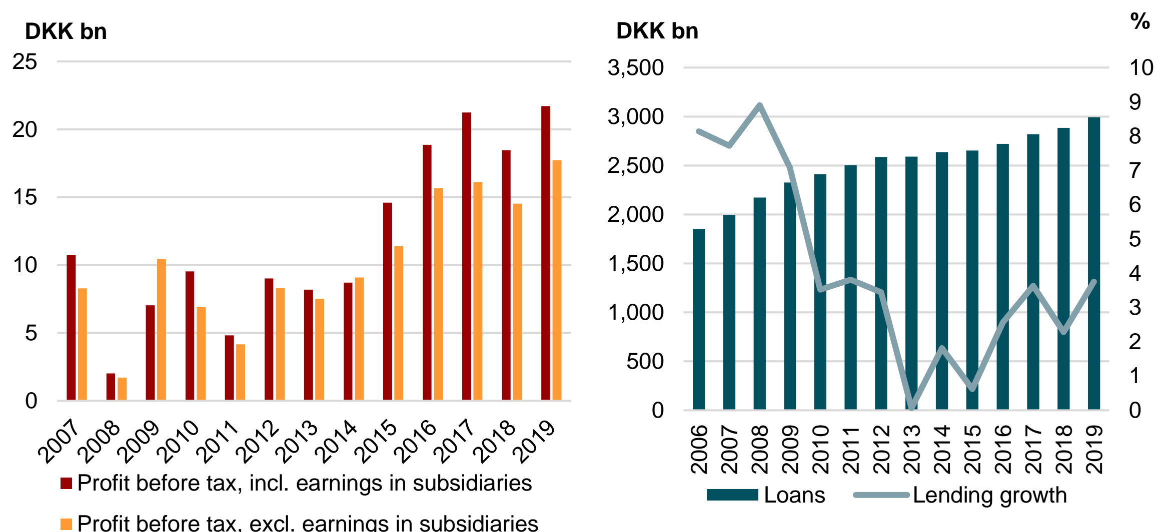
2. Mortgage credit institutions' earnings

Mortgage credit institutions' earnings rose in 2019 and remain at a high level from a historical perspective. The institutions' financial statements contain the following highlights for 2019[1]:

- Pre-tax profit increased by 17.7 per cent. The pre-tax return on equity rose from 8.6 to 9.7 per cent.
- The rise in profit can mainly be attributed to an increase in value adjustments.
- Net interest income increased by 3 per cent despite a decline in interest income.
- Fees and commission income increased by DKK 1.6 billion (55.6 per cent), while fees and commissions paid increased by DKK 2.6 billion. (40.2 per cent). This led to a decrease in net fee income.
- Loan impairments rose by 10.1 per cent, but this happened from a low starting point. The increase is primarily attributable to increases in impairments on private residential properties for rent, as well as on office and business properties.
- Lending increased by 3.8 per cent, which was supported by low bond yields and generally rising property prices.

The mortgage credit institutions' total pre-tax profit was DKK 21.7 billion in 2019, see Figure 2. Earnings rose in relation to a pre-tax profit of DKK 18.5 billion in 2018. Both inclusive and exclusive earnings in subsidiaries were at the highest level for the period 2007-2019. Lending also continued to rise from DKK 2,884 billion in 2018 to DKK 2,992 billion in 2019 and was also at the highest level for the period 2007-2019.

Figure 2: Earnings and lending increased in the Danish mortgage credit institutions

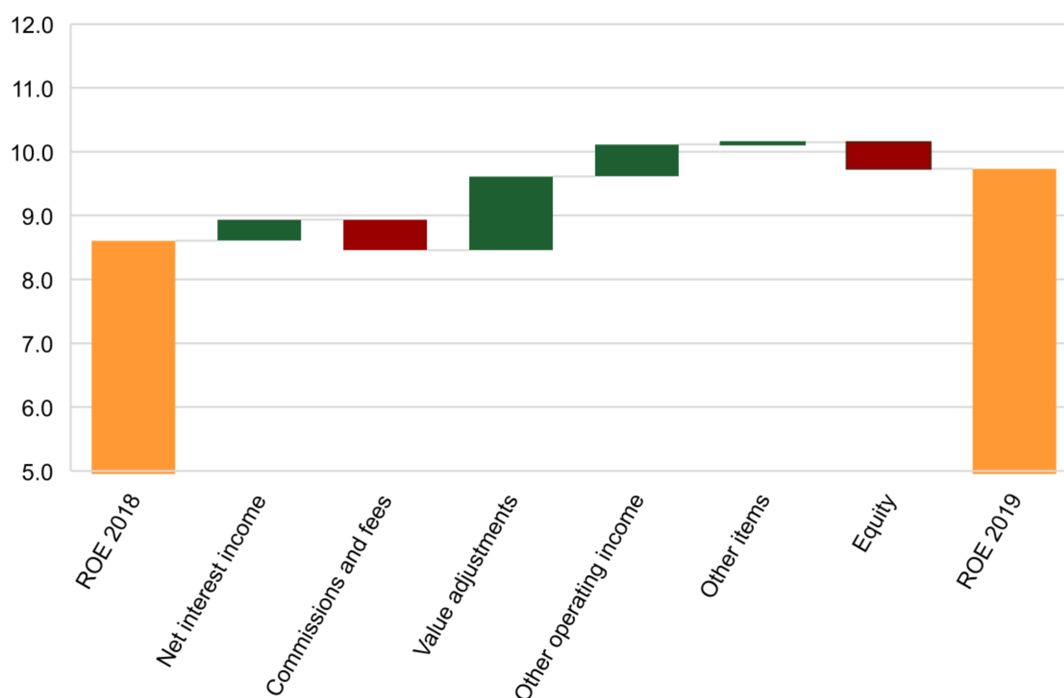


Note: The graph on the left shows the trend for the mortgage credit institutions' pre-tax profit, including and excluding the result of equity investments in associates and affiliates. Loans in the figure on the right are calculated excluding guarantees, after impairments and excluding loans to other MFIs.
Source: Reports to the Danish FSA.

1 The full financial statement and financial ratio table for mortgage credit institutions can be seen in Annexes 1 and 2.

Return on equity before tax indicates how much of a return on investment owners have received on capital invested[2]. The increase in the return on equity between 2018 and 2019 was mainly driven by higher capital gains on fund holdings that were widespread and driven by shares, bonds and derivatives, as well as by increased activity as a result of remortgaging. Figure 3 illustrates how mortgage credit institutions' expenditure and income categories affected the pre-tax return on equity between 2018 and 2019.

Figure 3: Increase in the return on equity, primarily driven by value adjustments

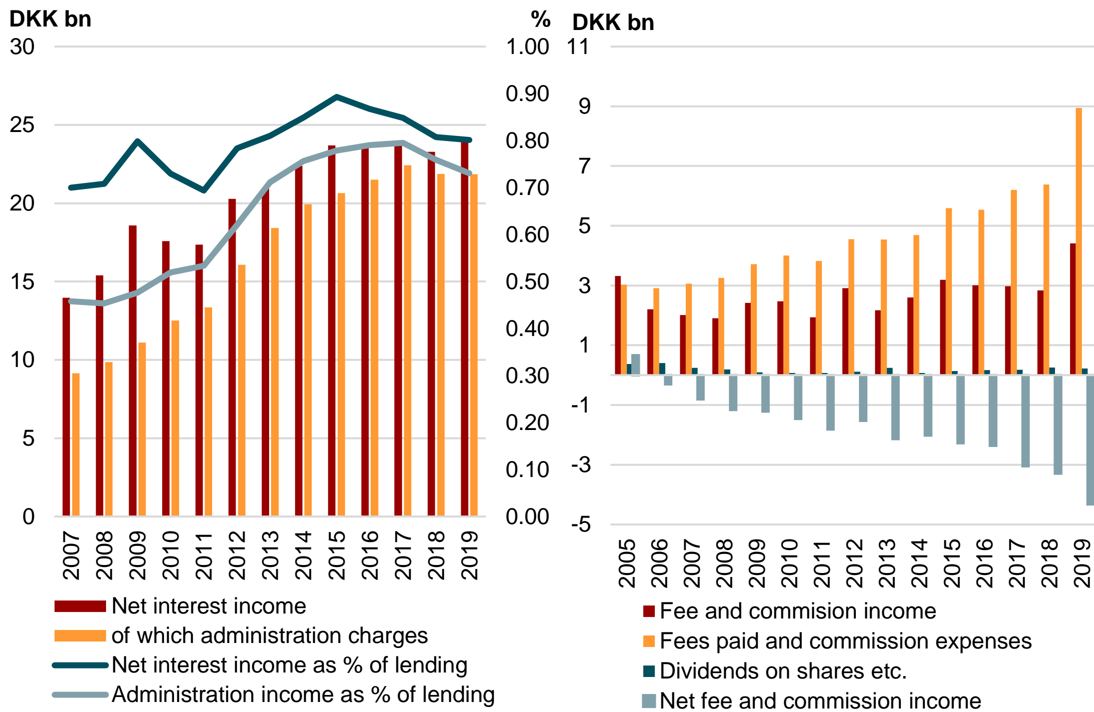


Note: The figure shows the factors which have affected the return on equity before tax (ROE) from 2018 to 2019. Other items include loan impairments and receivables, etc., the profit from equity investments in associates and affiliates, other operating expenses, staff and administration expenses, income from activities during liquidation and from amortisation and write-downs on intangible and tangible assets.
Source: Reports to the Danish FSA.

Administration charges in 2019 was on a par with 2018. Its amount fell relative to lending, see Figure 4. This is partly due to the fact that a number of borrowers chose loans with instalments and fixed interest rates, where the administration rate is generally lower. Figure 4 also shows that fee revenues and expenses increased substantially in 2019, which must be seen in light of the historically high remortgaging activity[3]. The remortgaging activity occurred as interest rates fell, and the difference between short-term and long-term interest rates continued to decrease in 2019. This development made it both attractive to convert from a higher to a lower fixed interest rate and to convert from a variable to a fixed interest rate loan. The remortgaging activity had a positive impact on the mortgage credit institutions' fee income, while the fees paid and commission expenses also increased, as the mortgage credit institutions pay fees to the banks for arranging their loans.

2 Profit before tax/equity.
3 Mortgage credit institutions routinely pass on a portion of their core earnings to the intermediary banks, which is included in the item fees and commission expenses. It generally supports the large difference between fees and commission income and fees and commission expenses.

Figure 4: Administration charges to lending decreased and fee income increased substantially

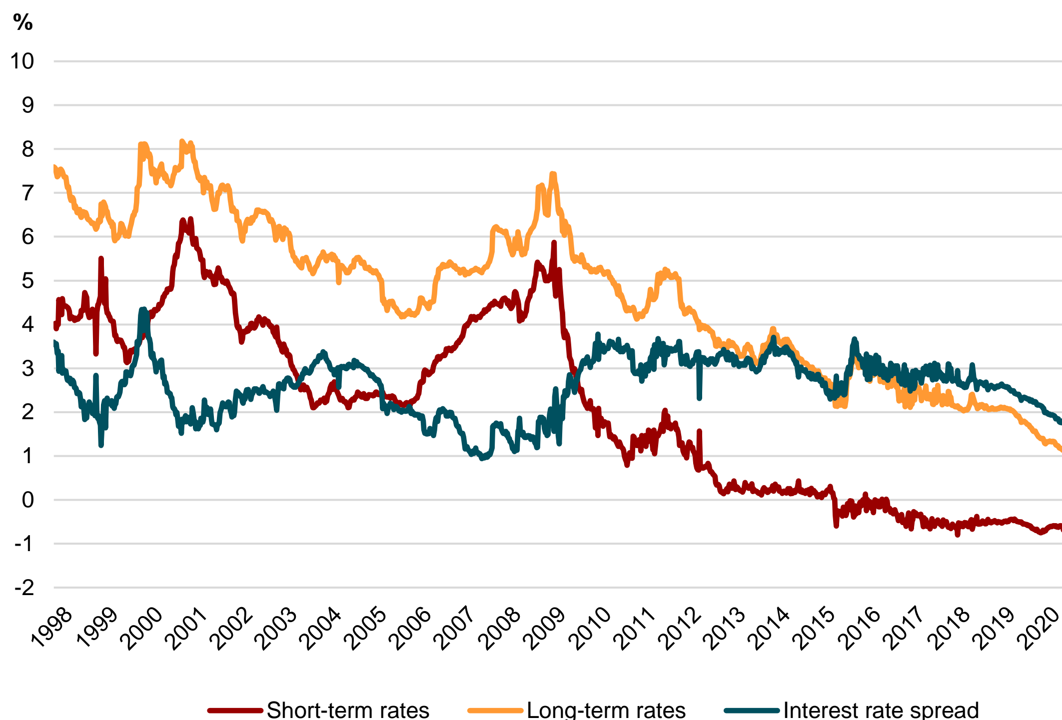


Note: Loans in the left graph are calculated after impairments and exclusive loans to other MFIs. Net interest earnings as % of lending and administration charges as % of lending are shown on the right axis.
Source: Reports to the Danish FSA.

3. Interest rate trends

The long-term and short-term mortgage interest rates fell overall in 2019, see Figure 5. The long-term interest rate fell more than the short-term one, leading to a fall in the interest rate spread between the two interest rates of 0.6 percentage points. The Danish mortgage bond market is generally considered a safe haven by investors. It was therefore as expected that the Danish mortgage credit rates continued to fall at the beginning of 2020, coinciding with the spread of the COVID-19 virus and the greater uncertainty on the financial markets which this entailed.

Figure 5: Interest rate level remained low



Note: The long-term interest rate covers 30-year fixed-rate, convertible newly-issued mortgage bonds during the relevant week. The short-term interest rate covers the one and two-year non-convertible newly issued mortgage bonds during the relevant week, which underlie the repayment of variable-rate mortgages.
Source: Finance Denmark.

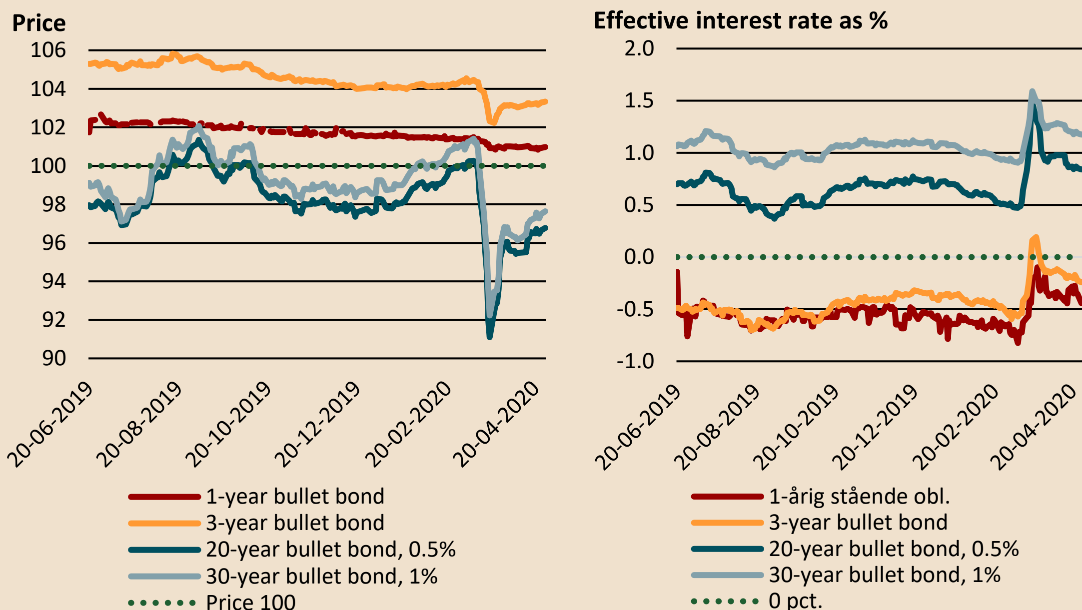
When Europe was hit by the COVID-19 pandemic, it generally caused major capital losses, including for oil, shares, credit bonds and even government bonds. The trend in Danish mortgage interest rates also reversed the week when COVID-19 impacted Denmark. Prices for Danish mortgage bonds fell significantly and interest rates rose, see Box 1. Prices for mortgage bonds have subsequently readjusted, but interest rates remain above the historically low levels immediately before the COVID-19 crisis. Measured in relation to the government bond curve, long-term convertible mortgage bonds are trading at the same spread as in the autumn of 2019[4].

4 The duration of convertible mortgage bonds is increased when interest rates increase due to their built-in conversion right (negative convexity), whereas the duration of government bonds in the event of interest rate increases is largely unchanged. In isolation, this results in an increased exchange rate spread for interest rate increases.

Box 1: The impact of the COVID-19 crisis on the mortgage bond market

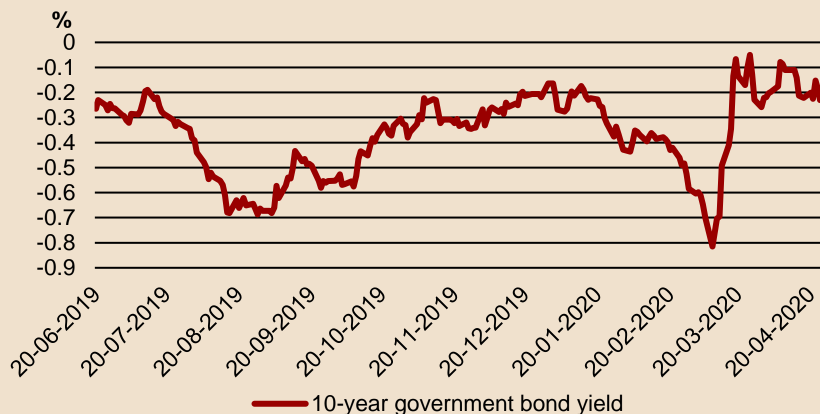
Uncertainty during the COVID-19 crisis has also impacted traditionally safe securities such as mortgage bonds and government bonds, which have provided a safe haven in other crises, see Figures 6 and 7. The mortgage credit market experienced major price drops during the week when the COVID-19 pandemic impacted Denmark, one of the reasons being that many investors did not want additional long-term items on the books in the uncertain market. In particular, it was long-term mortgage bonds which dropped in price. The price falls occurred in a market with limited turnover and did not reflect large sell-back transactions. Prices have subsequently readjusted and market participants are reporting the mortgage credit market's return to normal.

Figure 6: COVID-19 affected interest rates and prices for mortgage bonds



Note: The data covers selected mortgage bonds for the period from 20 June 2019 to 27 April 2020. The prices used are *Nasdaq CPH Consolidated reference prices*.
Source: Nasdaq.

Figure 7: Major increase in government bond yields due to COVID-19

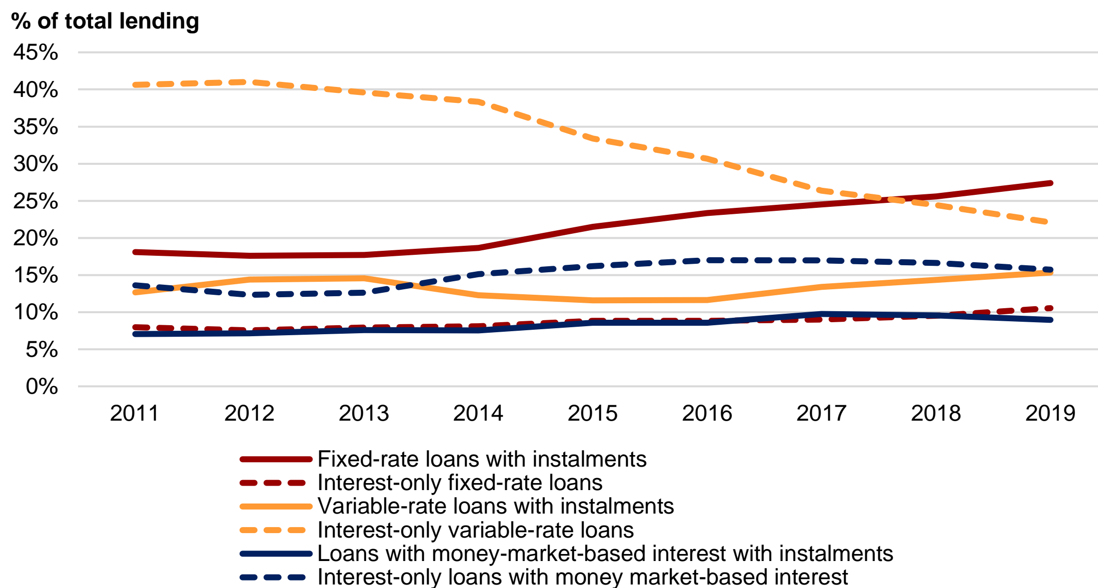


Note: Data for the period 20/06/2019 to 27/04/2020.
Source: Bloomberg.

4. Mortgage credit institutions' lending activity

The low interest rate level in 2019 coincided with positive lending growth for mortgage credit institutions. In 2019, the majority of mortgage credit institutions' lending consisted of loans involving fixed interest rates and instalments, see Figure 8. The amount of outstanding variable interest rate loans continued to decline. Loans involving instalments increased from 49.5 per cent of the mortgage credit institutions' lending portfolio to 51.7 per cent in 2019, while fixed-rate loans rose from 35.1 per cent in 2018 to 37.9 per cent in 2019[5].

Figure 8: Fixed-rate loans rose, while the number of interest-only variable-rate loans declined



Note: Lending is calculated as the mortgage credit institutions' loans secured by mortgages on property before impairments at fair value at the end of the period. Index loans are not included. Interest-only mortgage loans include interest-only mortgage loans where the option is both currently exercised and not currently exercised.
Source: Reports to the Danish FSA.

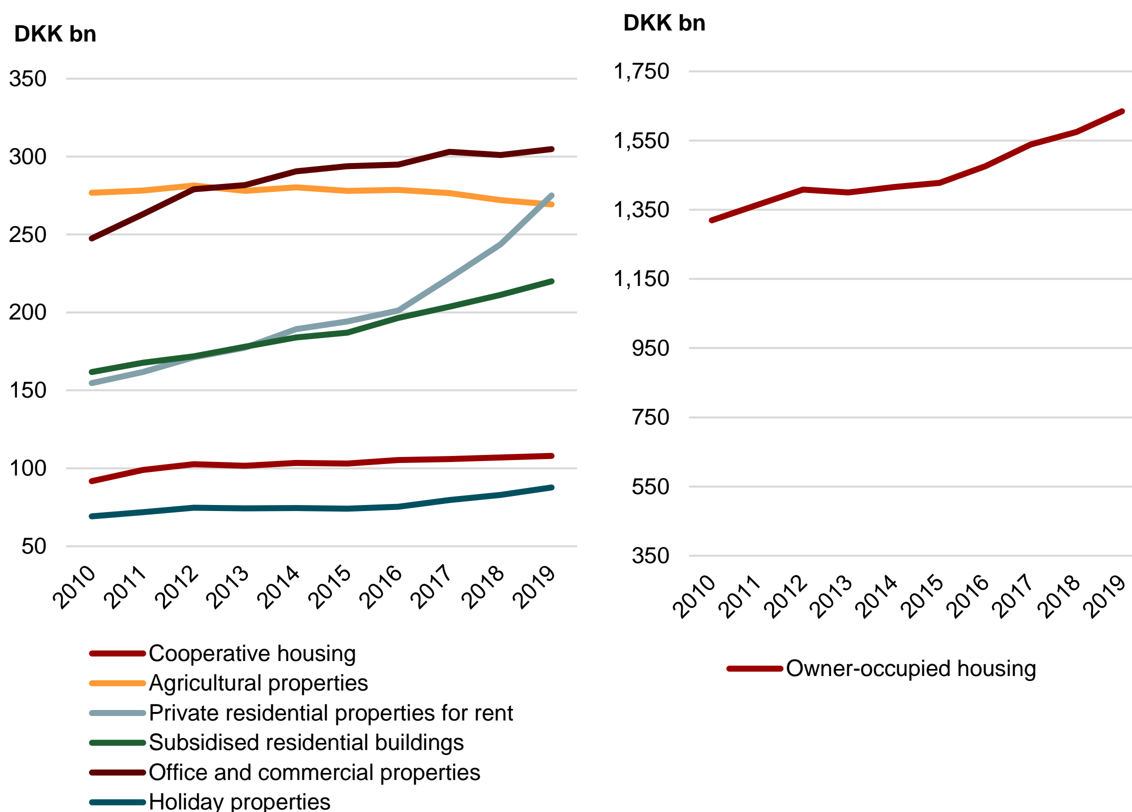
The fact that more borrowers chose fixed-rate loans must be viewed in light of the historically low interest rate level and the decreasing interest rate spread between the short-term and long-term mortgage rates in 2019, which made it cheap and attractive for borrowers to protect themselves against future interest rate increases. In addition, the guidelines for access to risky loans restrict mortgage credit institutions from granting customers with a high LTV ratio and debt factor the riskier types of loans, see Chapter 7. In 2019, for the first time in Denmark in the history of mortgage lending, the possibility emerged of 10-year convertible mortgage credit loans with a negative fixed interest rate of -0.5 per cent. This type of loan had, as of early March 2020, a circulating amount of around DKK 1.8 billion[6].

Mortgage credit institutions' lending rose in 2019 for the majority of the property categories, see Figure 9. The only exceptions were agricultural properties and properties for social, cultural and educational purposes, with loans falling by 1.0 and 0.3 per cent respectively. At the

5 Index loans are not included in these calculations.
6 Source: Nasdaq. The circulating amount denotes the amount of the total bond issue that is in circulation.

top of the list were private residential properties for rent, where lending increasing by 12.8 per cent.

Figure 9: Lending for owner-occupied housing and residential rental properties is sharply on the rise



Note: Lending is calculated as the mortgage credit institutions' loans before impairments at fair value at the end of the period. Index loans are not included. Industrial and handicraft business properties, as well as properties for social, cultural and educational purposes are not included in the figure, as mortgage lending for both of these property categories was rounded below DKK 50 billion in 2019.
Source: Reports to the Danish FSA.

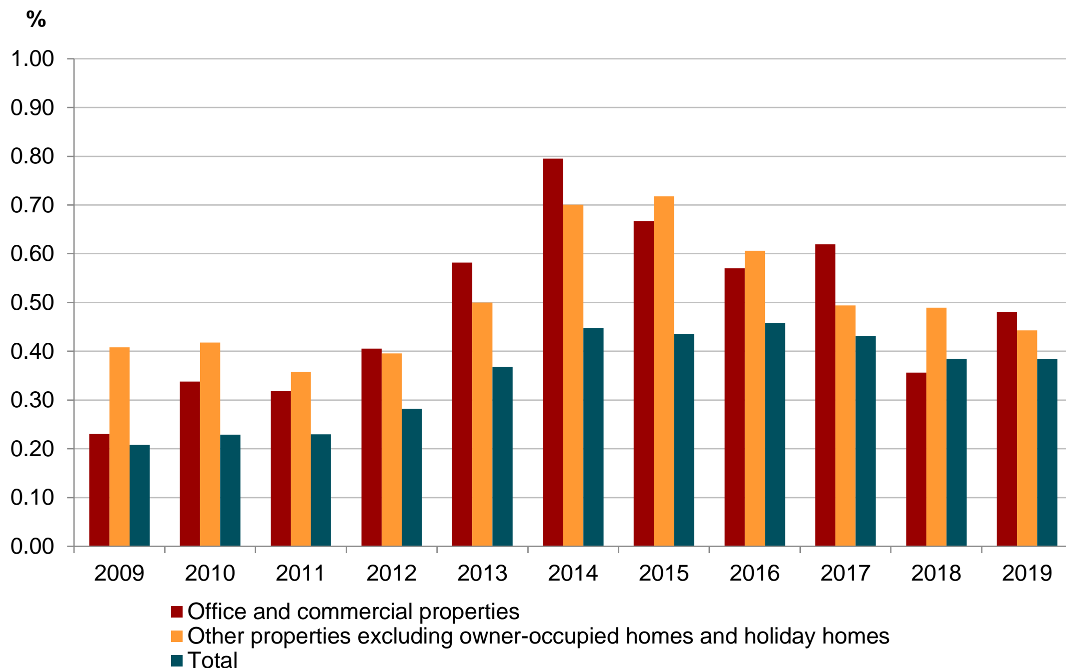
Mortgage credit loans for office and business properties accounted for the majority of commercial lending in 2019, see Figure 9. Office and business properties include retail stores, restaurants, hotels, recreational facilities, conference and training centres. These are all properties in sectors which stand to be severely affected during the COVID-19 crisis, with many of them having been forced to close since mid-March. There is a risk that a number of companies in these sectors will not be able to pay their rents as long as the outbreak of COVID-19 and restrictions on their operations continue[7]. If this trend continues and spreads, it may affect mortgage credit institutions, as property owners may be unable to pay the instalments on their loans. There is the added problem that certain sectors, including clothing stores, have already been subject to pressure by competition from e-commerce.

Figure 10 shows the trend in the mortgage credit sector's impairment rates for loans for office and business properties, other properties excluding owner-occupied homes and holiday

7 The Government has launched a number of initiatives aimed at alleviating the losses suffered by companies as a result of the COVID-19 crisis, including for instance, businesses which have leases in mortgage-financed commercial properties.

homes and total lending respectively. The impairment rate on loans for office and business properties has historically been higher than for total loans, but on par with loans for other properties. Overall, the impairment rates have followed the same trend throughout the period. The impairment rate may rise as a result of the COVID-19 crisis, including as a result of possible lockdowns and potential bankruptcies affecting retail stores, hotels and restaurants, etc.

Figure 10: Relatively high impairments on office and business properties

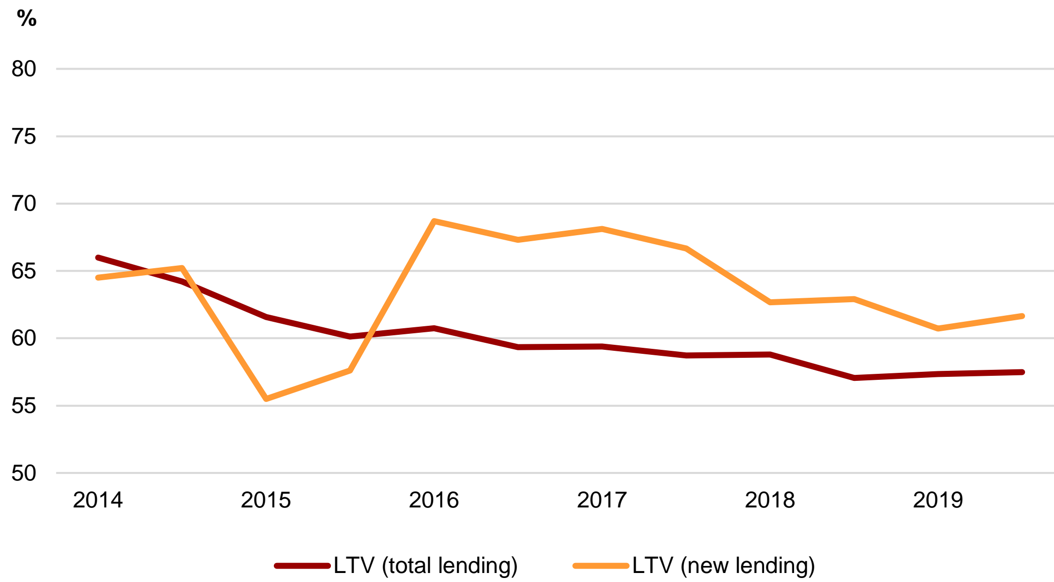


Note: The impairment rate is defined as the accumulated impairments for the year in relation to mortgage credit loans before write-downs. Other properties, excluding owner-occupied and holiday homes, covered by mortgage lending include subsided buildings for housing, cooperative housing, private residential rental properties, industrial and handicraft association properties, agricultural properties, social, cultural and educational properties, as well as other properties. In total, mortgage credit loans for owner-occupied homes and holiday homes are also included.
Source: Reports to the Danish FSA.

LTV ratios

Mortgage credit institutions' loan-to-value (LTV) ratio expresses the ratio of the loans with security in the properties to the values of these properties. For total mortgage lending, the average LTV ratio has overall been in decline since 2014, see Figure 11, as a result of rising housing prices and the fact that more people are choosing mortgages with instalments. The average LTV ratio for new loans has been more volatile over the same period, but has fallen by 7 percentage points since 2016, and the gap with the average LTV ratio for total lending has decreased. At the end of 2019, the average LTV ratio for total lending and new lending was 57 per cent and 62 per cent respectively.

Figure 11: Average LTV ratio fell in 2019

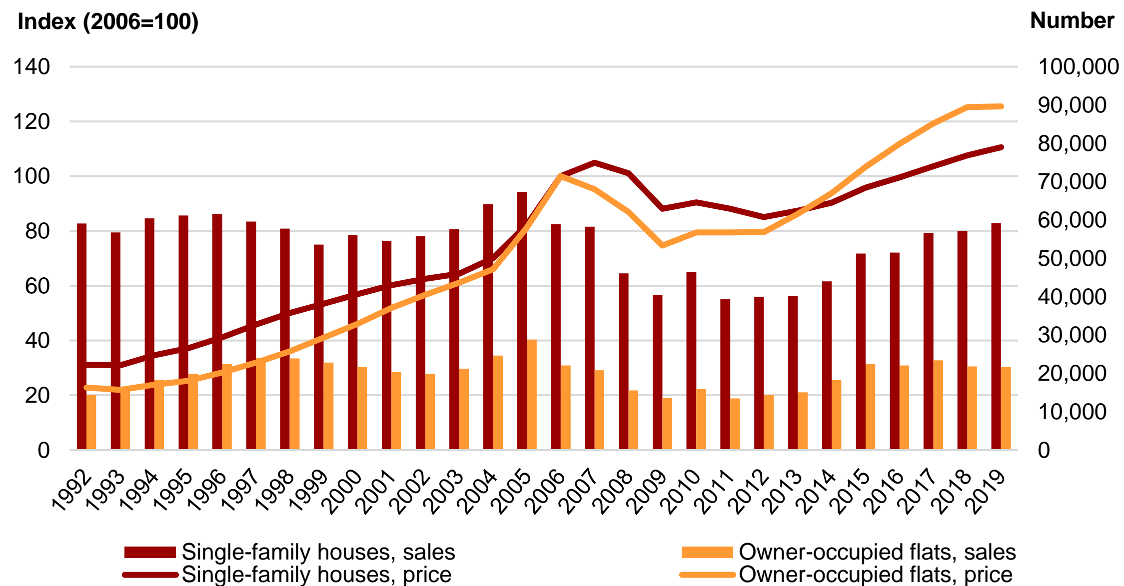


Note: The LTV ratio is calculated as a simple average of the mortgage credit institutions' exposure-weighted LTV ratios for loans.
Source: Reports to Danish the FSA.

5. Property market

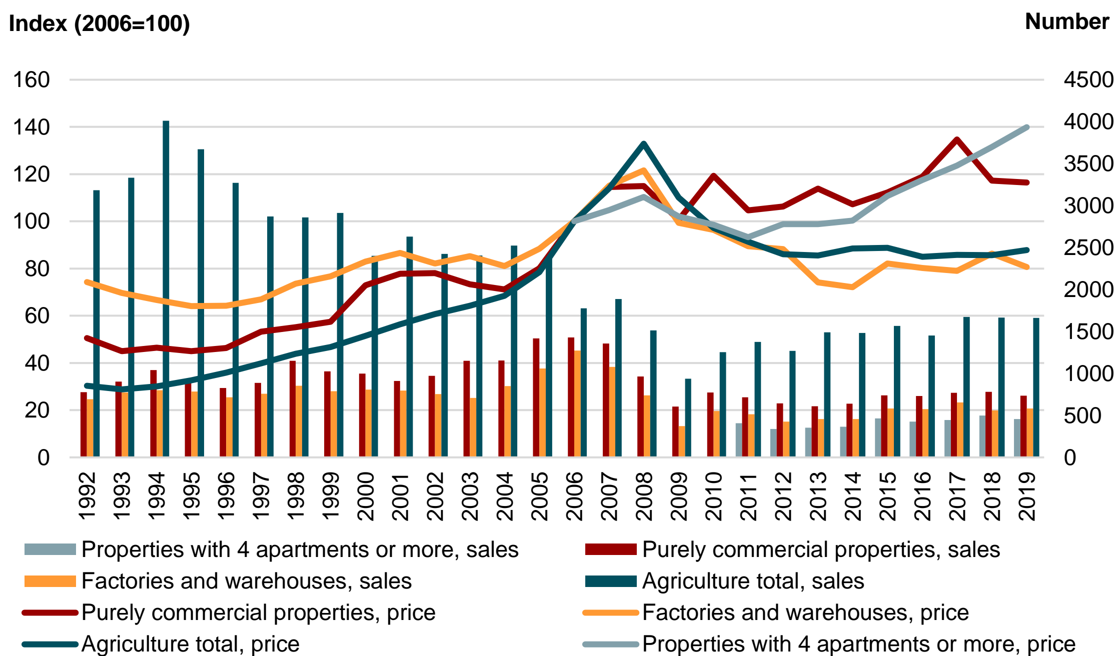
The low interest rate level in 2019 also coincided with overall rising property prices, and the number of sales increased for single-family houses as well as for factory and warehouse properties, see Figures 12 and 13[8].

Figure 12: Prices of owner-occupied houses rose



Note: The number of sales covers the total sales and is shown on the right axis.
Source: Statistics Denmark.

Figure 13: Prices rose for several selected property categories



Note: The price trend for properties with four or more apartments is used here as a measure of the price trend for rental properties. The number of sales covers annual sales with a price calculation and is shown on the right axis.
Source: Statistics Denmark.

8 Based on the selected property categories as shown in the figures.

Interest rate increases result in higher payments on new loans and variable rate loans. Therefore, all things being equal, interest rate increases will have an adverse effect on property prices. The effect will be amplified if it coincides with borrowers generally refraining from property purchases or an economic downturn, including as a result of COVID-19.

The COVID-19 crisis is expected to cause a fall in housing prices. At the beginning of April, the Danish Economic Councils published an analysis of the situation in which they set out two scenarios[9]. According to the analysis, prices for single-family houses are expected to fall between 8.2 and 11.1 per cent in 2020.

The COVID-19 crisis may also affect the prices of other property categories. This may happen, for example, as a result of lower expectations of the earning potential generated through, among other things, office and business properties.

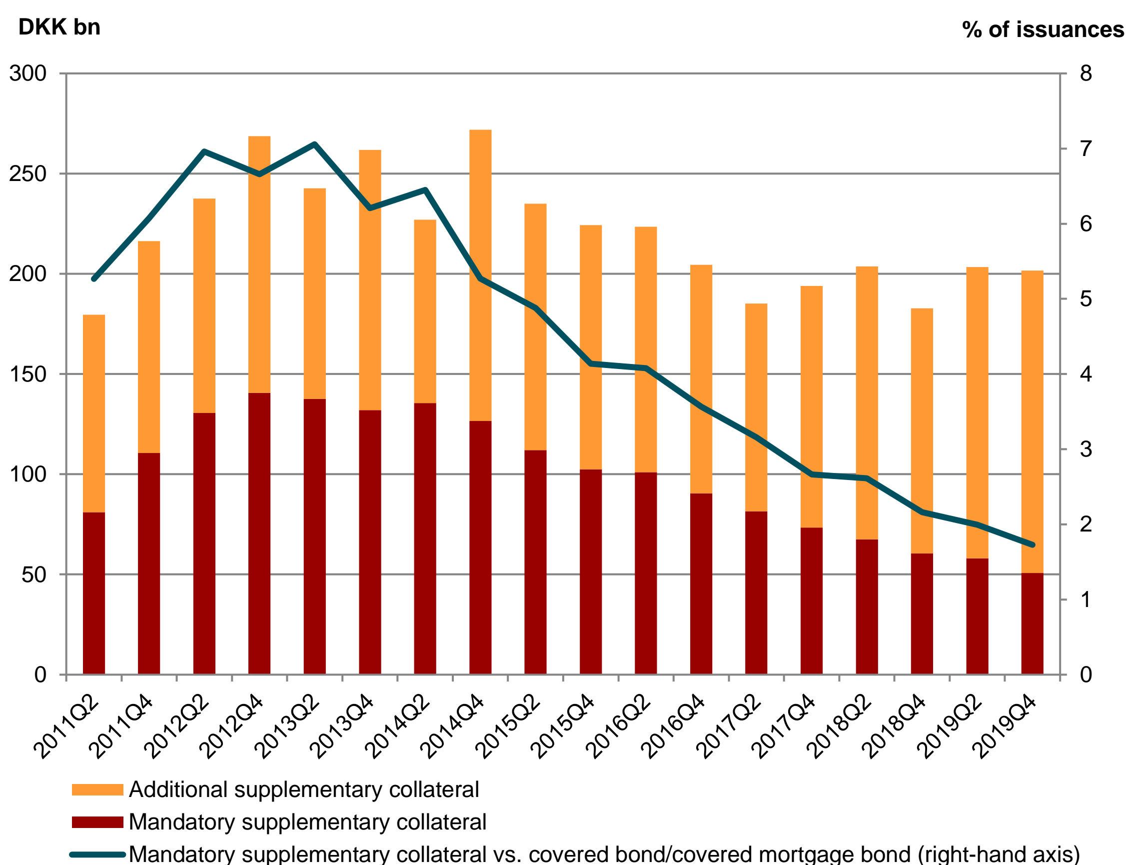
9 https://dors.dk/oevrige-publikationer/prognoseopdatering/corona-scenarier-dansk-oekonomi-offentlige-finanser.

6. Supplementary collateral

The requirement for supplementary collateral under Danish covered bonds legislation obliges mortgage credit institutions issuing covered bonds and covered mortgage bonds to provide compensatory collateral to bond holders if property prices fall so much that the loan limit is exceeded.

Conversely, a favourable economic climate with rising property prices reduces the need to post supplementary collateral for mortgage credit institutions when the level of lending is unchanged. Figure 14 shows that the statutory requirement for supplementary collateral has declined since late 2012.

Figure 14: The statutory requirement for supplementary collateral has declined



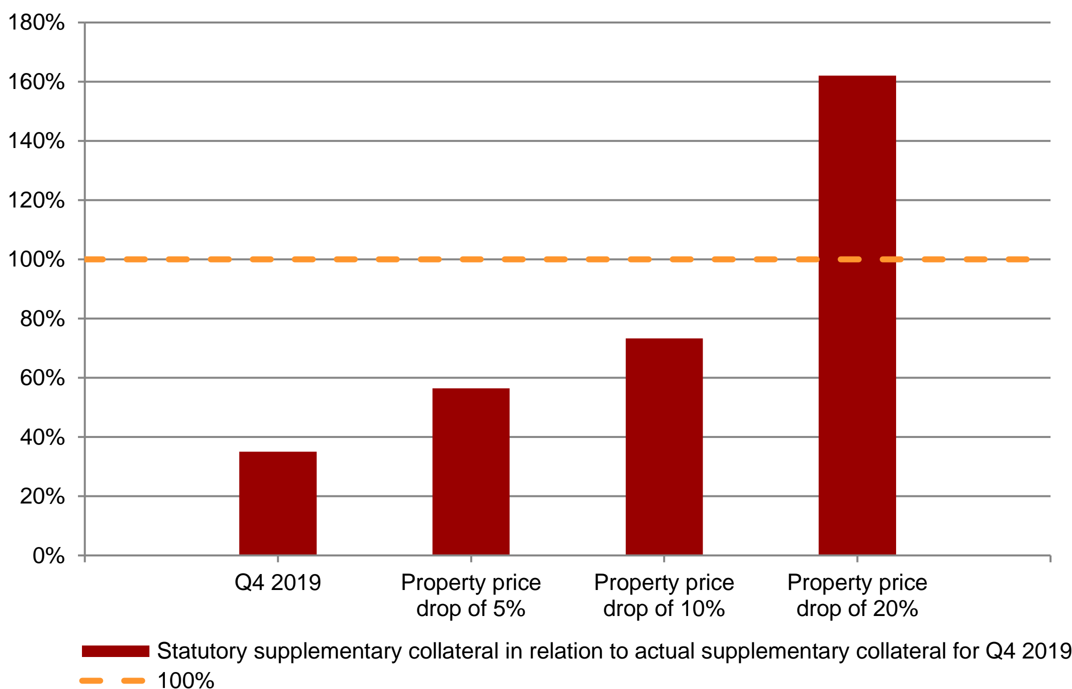
Source: Reports to the Danish FSA.

If property prices fall drastically, individual mortgage credit institutions may be forced to obtain financing from the market to meet the supplementary collateral requirement[10]. Mortgage credit institutions typically have sufficient capital adequacy to meet the statutory requirement for supplementary collateral so that, among other things, they can obtain a high credit rating for the bonds. Additional supplementary collateral for Q4 2019 amounted to DKK 151 billion, as opposed to DKK 122 billion for the same period the previous year.

10 Only particularly safe asset types can be used as supplementary collateral. In practice, they are predominantly government bonds and exposures to credit institutions, including, under certain conditions, guarantees from credit institutions.

Mortgage credit institutions stress-test and annually assess the impact of a property price drop on their statutory supplementary collateral. Figure 15 shows the impact that a decline in property prices of 5, 10 and 20 per cent respectively is expected to have on the mortgage credit institutions' statutory requirement to provide supplementary collateral in relation to the actual supplementary collateral posted as at Q4 2019, when all other factors are retained. This is compared to the total supplementary collateral posted in Q4 2019.

Figure 15: Mortgage credit institutions should be able to counteract major property price drops



Note: The figure shows statutory vs. supplementary collateral actually provided as at Q4 2019 and the statutory supplementary collateral vs. supplementary collateral actually provided as at Q4 2019 in the event of a property price drop of 5, 10 and 20 per cent respectively, estimated by selected mortgage credit institutions.
Source: Reports to the Danish FSA.

At sector level, the selected mortgage credit institutions still expect to be able to absorb a property price drop of more than 10 per cent with their most recently reported supplementary collateral, when all other factors are retained. A general property price drop of 20 per cent will, on the other hand, mean that the statutory requirement for supplementary collateral will be greater than the mortgage credit institutions initially anticipated at the end of 2019, see Figure 15. This is potentially one of the biggest risks for the mortgage credit sector. The Danish mortgage credit model is otherwise generally structured with the aim of ensuring that risks other than credit risk, such as liquidity and market risks, do not significantly affect the mortgage credit institution.

7. Supervision and regulation

The Danish FSA strives to ensure that supervision and regulation continuously help reduce the overall risks for mortgage credit institutions, consumers and businesses, and reinforce financial stability.

Mortgage credit given COVID-19 exemption
From mid-March 2020, the Danish FSA has decided to grant a temporary exemption from the requirement that internal inspections must be carried out during the mortgage credit institutions' valuation of primarily residential properties. This is being done to minimise the risk of spreading the infection.

Mortgage credit institutions can therefore price properties and provide loans without physically entering the properties, if they consider that the basis for assessing the properties' value is adequate. Therefore, in the coming period, external inspection of owner-occupied properties will be sufficient. The exemption ensures that mortgage credit institutions can continue to provide loans, thereby helping to support the housing market.

The exemption increases the risk of incorrect valuation of properties, but the FSA considers that the risk is limited, one of the reasons being that the right to grant an exemption is only temporary. The institutions will register the cases where they have used the right to grant an exemption, and the FSA will follow up on these if it is considered relevant.

Supervisory Diamond is now fully implemented
The Supervisory Diamond for mortgage credit institutions is a supervisory instrument designed to prevent excessive risk taking by individual mortgage credit institutions. It was introduced in 2014 with partial effect from 2018 and full effect from 2020.

The Supervisory Diamond for mortgage credit institutions contains five benchmarks which broadly limit the risk in mortgage credit institutions[11].

1. Restricting **lending growth** (in segments) lowers the risk that excessive growth will occur at the expense of credit quality and that a mortgage credit institution will therefore end up with bad loans on the books.

2. Restricting **borrowers' interest rate risk**. Customers with variable-rate loans run the risk that their monthly payments will increase significantly when the new interest rate is to be fixed. As a result, the institutions have a higher credit risk than with fixed-rate loans. At the same time, an interest rate increase can affect many customers simultaneously, which poses a significant concentration risk for mortgage credit institutions. The benchmark addresses this risk by limiting the proportion of the loan portfolio that is variable-interest (with a fixed-interest term of up to two years) and where the LTV ratio is relatively high.

3. Restricting **interest-only periods for private individuals**. Interest-only periods increase the credit risk in mortgage credit institutions if customers do not use the interest-only period to consolidate in other ways. This is especially true with high LTV ratios, where

11 The Supervisory Diamond's benchmarks with associated boundaries are shown in Figure 16.

the institutions are most at risk of losses in the event of declining property prices. The benchmark addresses this risk by limiting the proportion of the loan portfolio with relatively high LTV ratios involving interest-only loans.

4. Restricting **loans with short-term funding** ensures a certain resilience in the mortgage credit system in relation to situations where it may prove difficult for various temporary reasons to refinance matured bonds. The quarterly part of the benchmark is intended to limit the risk of short-term refinancing problems, while the annual part of the benchmark aims to limit the risk of longer-term challenges in refinancing matured bonds. The benchmark therefore ensures that a refinancing auction with, for instance, low investor demand for the bonds in question both affects mortgage credit institutions less and affects fewer borrowers.

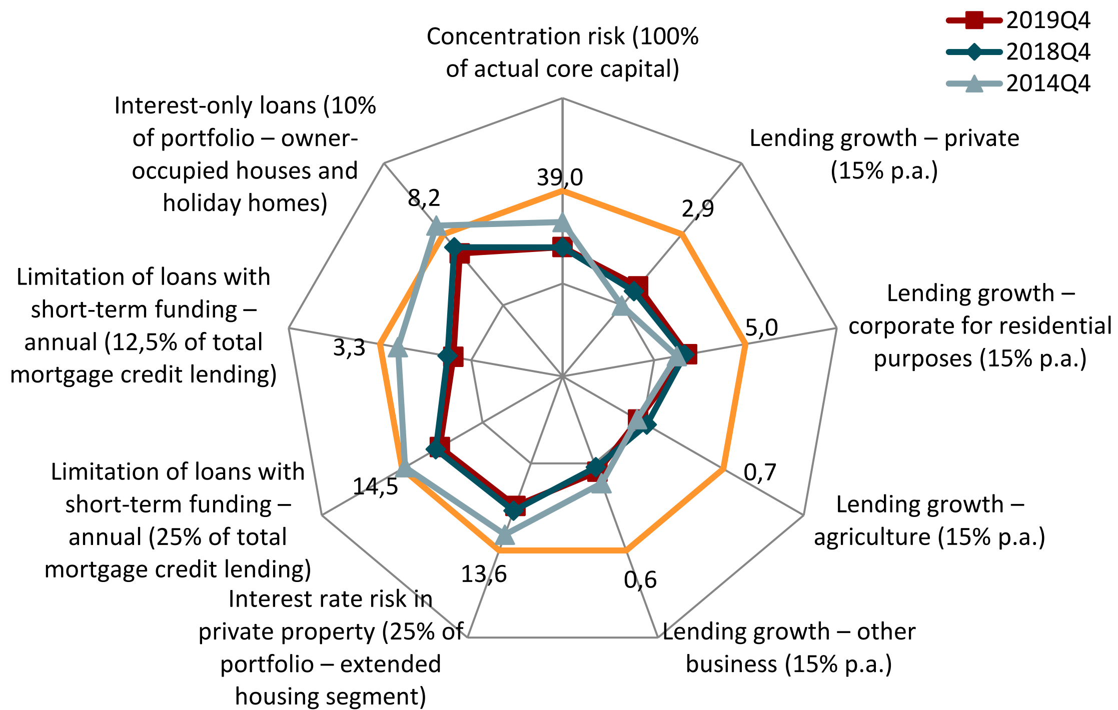
   The Supervisory Diamond's benchmark on the refinancing risk is supplemented by the interest rate trigger in the Danish Mortgage Credit Act. The interest rate trigger means that matured bonds can be extended by 12 months at a time if there are no purchasers for all the necessary new bonds to refinance the matured bonds. The interest rate trigger is an emergency solution to refinancing problems.

5. Restricting the **concentration risk** ensures that a large part of the mortgage credit institution's exposures are not concentrated on a few large customers, which could otherwise lead to significant losses for the mortgage credit institution if even just one large customer get into difficulties.

In fourth quarter of 2019, the mortgage credit institutions were, at sector level, largely compliant with all of the Supervisory Diamond's benchmarks, see Figure 16[12]. Since 2014, mortgage credit institutions at sector level have moved further within the framework for the majority of benchmarks. So far, two mortgage credit institutions have received a risk warning, in both cases as a result of exceeding lending growth.

12 Sector level is calculated as all mortgage credit institutions taken together.

Figure 16: All benchmarks in the Supervisory Diamond are complied with at sector level



Note: The figure shows where mortgage credit institutions were placed at sector level in 2014, 2018 and 2019 (grey, blue and red lines), in relation to the benchmarks in the Supervisory Diamond (yellow line). The benchmark for lending growth and loans with short-term funding is divided into subcategories. The values in the figure belong to the red line – Q4 2019.
Source: Reports to the Danish FSA.

Status of best practice reports – tackling risky loans

The guidelines for best practice for mortgage credit define a number of loans as risky, see Box 2. Credit institutions should not, as a rule, provide risky loans to high-debt customers.

Box 2: Best practice for risky loans

New guidelines for best practice in granting mortgage credit came into effect on January 1st 2018. They generally prevented credit institutions from granting risky real estate loans to households with high debt.

According to the new guidelines, a loan is regarded as risky if the borrower has a debt factor (debt as a proportion of income) of more than 4 and an LTV ratio of more than 60 per cent, as well as one of the following loan types:

- Loan with a variable-interest rate with a fixed-interest period of less than five years, with or without instalments
- Loan with interest-only and variable-interest rate with a fixed-interest period of five years or more.

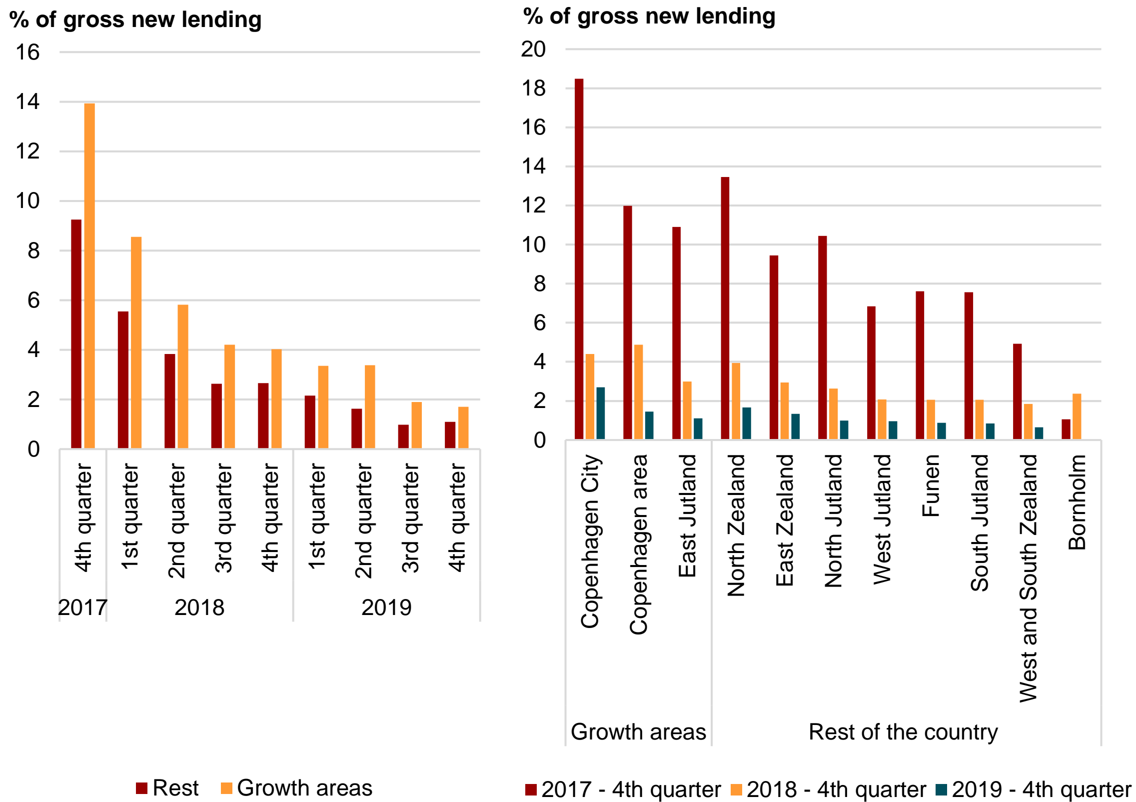
The objective of the new guidelines is to protect households with high debt so that they are able to withstand interest rate increases without getting into financial problems. Concurrently with publication of the new guidelines, the Minister for Industry, Business and Financial Affairs asked the Danish FSA to monitor trends in risky loan types. The first report was for the reference period of Q4 2017.

Risky loans may be still be granted because the institutions have the option to deviate from the guidelines in certain specified exceptions. However, a relatively high proportion can also indicate that the institutions have not fully implemented the guidelines. The Danish FSA is regularly in dialogue with institutions with sizeable proportions of risky loans and will address inadequate implementation of the rules with supervisory responses.

The Danish FSA has observed a continued positive development, where the proportion of risky new lending in growth areas fell to 1.7 per cent in Q4 2019 against 4.0 per cent in Q4 2018, see Figure 17[13]. Outside growth areas, the proportion fell from 2.7 per cent to 1.1 per cent in just a year. The proportion of risky loans in Q4 2019 continued to be higher in the city of Copenhagen than in the rest of the country. However, the proportions fell significantly across the regions.

13 Covers mortgage credit loans and similar loans made by banks.

Figure 17: Fewer risky new loans



Note: Gross new lending is calculated according to the guidance on mortgage lending for customers with high debt factors: https://www.finanstilsynet.dk/Ansoeg-og-Indberet/Indberetning-for-finansielle-virksomheder/System/KGFS.
Source: Reports to the Danish FSA.

Examination of 30-year interest-only periods

Most mortgage credit institutions are offering a new type of mortgage that differs substantially from traditional mortgages which are interest-only for up to 10 years. The new type of home loan allows for a long-term interest-only period of up to 30 years – for a maximum of 60 per cent of the property value – combined with a variable-interest rate under certain conditions. One of these conditions is that the property does not significantly decrease in value during the term of the mortgage. If this happens, the institution will be able to require the customer to pay off the loan by instalments anyway. The new types of loan entail more risks for borrowers, which increases expectations for the mortgage credit institutions and the banks providing the loans, see Box 3.

Box 3: New loan types

The new types of loan entail more risks for borrowers and are aimed at a more clearly defined target group than ordinary mortgage credit loans. Borrowers' finances must be sufficiently robust so that they can, for instance:

- cope with interest rate increases
- tolerate their debt not being continuously reduced
- tolerate the situation that their debt will still have to be repaid during the term if the LTV ratio changes drastically.

In addition, it is important that borrowers have a plan for how the debt will be repaid in time, without causing a situation where borrowers risk ending up with a home which they cannot afford to live in.

This requires the mortgage credit institutions and banks which arrange the loan to focus on which customers are suitable for the loan and especially on those who are not suitable for it. This must be reflected in the marketing for the loan type and guidance and advisory material must ensure that the borrower is aware of the loan's features and requirements with regard to the person's finances.

In case of loans with long-term interest-only periods, the particular challenge involved is that it may be difficult for borrowers to relate to a distant future. This in turn may lead to a sense of over-optimism in relation to any future challenges.

The Danish FSA has initiated a study looking at which procedures mortgage credit institutions have followed when developing the products[14]. The study focuses in particular on whether the institutions have defined a target group for the product and tested how this target group could handle any financial stress. The study also looks at how the institutions advise customers on the type of loan, both when the agreement is concluded and during the term of the loan. In light of all this, the Danish FSA will announce what is best practice when the institutions sell these types of loans to consumers and how they should treat customers during the term of the loan.

Box 4: Product approval procedure rules

Mortgage credit institutions and banks must have procedures for developing new products. The procedures must ensure that each institution establishes a relevant target group for which the new product is appropriate and identifies those customers for whom the product is not suitable. The procedures must also ensure that the institution tests the product to assess how it will affect customers in a variety of scenarios, including stress scenarios. The institutions must provide any distributors with information about target groups to ensure that the products are only distributed to relevant customers, and they must monitor the product after it is marketed.

14 See Box 4 for further rules on product approval procedures.

Status of use of the general balance principle
In June 2018, the Danish FSA published best practice principles for adhering to the general balance principle.

At the end of 2018, the Danish FSA asked mortgage credit institutions how they were complying with the new principles. On 19 December 2019, the Danish FSA published an updated version of the June 2018 article based on the institutions' replies.

Based on the follow-up, the Danish FSA can confirm that two out of six mortgage credit institutions (including a group with two mortgage companies) currently use the degrees of freedom featuring in the general balance principle.

The updated article contains the following additions:

- The principles will also be widely applied in a modified form to Denmark's Ship Finance and Danske Bank's covered bond issuances.

- The framework for issuances where a derivative link is needed to reduce imbalances should not exceed 10 per cent of total issuances.
  - This only applies to issuances which finance properties located in Denmark.
  - A group approach can be taken when companies are involved, where both parent and subsidiary companies issue bonds.
  - If the framework is greater than 5 per cent, it places greater demands for management involvement and risk management.

In their choice of product offerings, the institutions should also explicitly consider the consequences of the product offering for the funding side.

Status of the covered bonds directive
On 18 December 2019, two new EU regulations on covered bonds were published:

- Directive (EU) 2019/2162 of the European Parliament and of the Council of 27 November 2019 on the issue of covered bonds and covered bond public supervision and amending Directives 2009/65/EC and 2014/59/EU

- Regulation (EU) 2019/2160 of the European Parliament and of the Council of 27 November 2019 amending Regulation (EU) No 575/2013 as regards exposures in the form of covered bonds.

The Directive sets out the frameworks for issuing and supervising the issuance of covered bonds. The directive is intended to replace the earlier general definition of covered bonds in the UCITS directive. In other words, principles are being set out for bonds to safeguard investors' legal position. This includes requirements for suitable assets, use of derivatives, liquidity, supervision and labelling of covered bonds.

The amendment to the regulation tightens the requirements for covered bonds which are subject to preferential treatment. The key aspect for Denmark is that a requirement for a minimum level of overcollateralisation is introduced and that the monitoring frequency is increased for residential properties.

The directive must be implemented in Danish law if the provisions are not already covered by existing legislation. In addition, the level of the new overcollateralisation requirement from the amending regulation must be determined and implemented.

The implementation itself is aimed at providing at least a consolidation law, which must amend the relevant provisions of the Danish law on mortgage credit loans and mortgage credit bonds, etc., the Financial Business Act, the law on a ship finance institution and the law on restructuring and liquidation of certain financial establishments.

The Danish regulation of covered bonds is already largely in line with the directive's requirements. However, the legal basis will contain some material changes that will lead to new requirements for the issuing institutions:

- requirements for coverage and overcollateralisation
- introduction of new liquidity requirements for the institutions
- information for investors
- valuation of all immovable property at market value (which is the main rule in Denmark today).

In addition, the changes will entail some adjustments of a mainly formal nature concerning:

- licence provisions
- intragroup joint funding
- general adaptation to new definitions and disclosure requirements.

The changes are being discussed with industry representatives and Finansiel Stabilitet during the spring of 2020. The bill is scheduled to be heard in the autumn of 2020 and tabled in February 2021.

The directive must be implemented by 8 July 2021 and must apply from 8 July 2022 at the latest. The amendment to CRR, Article 129, will come into force at the same time, with the same deadline for implementation and application as the directive, i.e. 8 July 2022.

FINANSTILSYNET

8. Annex 1: Financial statements of mortgage credit institutions 2015–2019

	2015	2016	2017	2018	2019	Change, 1 year	Change, 5 years
Income statement	*DKK millions*					*%*	
Interest income	86,939	78,223	73,150	69,524	67,766	-2.53	-22.05
Interest expenses	63,252	54,625	49,236	46,251	43,790	-5.32	-30.77
Net interest income	***23,686***	***23,599***	***23,914***	***23,274***	***23,975***	***3.02***	***1.22***
Dividends from assets, etc.	134	173	177	252	217	-13.89	62.14
Fee and commission income	3,186	3,013	2,973	2,833	4,409	55.62	38.38
Fee expenses and commission	5,595	5,542	6,197	6,380	8,946	40.23	59.90
Net interest and fee income	***21,412***	***21,243***	***20,866***	***19,980***	***19,656***	***-1.62***	***-8.20***
Expenses for staff and administration	4,828	5,876	5,561	5,373	5,077	-5.51	5.15
Other operating income	105	1,126	1,239	1,995	3,074	54.07	2833.76
Other operating expenses	137	266	202	162	204	26.02	49.00
Amortisation and write-downs of intangible and tangible assets	2,155	176	237	99	284	186.28	-86.82
Basic earnings	***14,396***	***16,052***	***16,106***	***16,340***	***17,165***	***5.04***	***19.23***
Value adjustments	- 1,132	805	870	- 916	1,562		
Loan write-downs and receivables, etc.	1,868	1,209	874	905	996	10.13	-46.67
Profit from investments in associates	3,195	3,206	5,134	3,933	3,987	1.38	24.80
Profits before tax	**14,591**	**18,853**	**21,236**	**18,453**	**21,717**	17.69	48.84
Tax	3,098	3,359	3,417	2,980	3,317	11.31	7.09
Net profit for the year	**11,493**	**15,494**	**17,820**	**15,473**	**18,400**	18.92	60.10

Note: The figures are based on the institutions that existed in the individual years. The table shows selected items. In 2019, the mortgage credit sector consisted of Nykredit Realkredit, Realkredit Danmark, Totalkredit, Jyske Realkredit, DLR Kredit, LR Realkredit and Nordea Kredit. In the profits from investments and equity, Totalkredit is a double entry due to it being part of the Nykredit Group. The profits from investments can mainly be attributed to subsidiaries in Nykredit Realkredit: Totalkredit and Nykredit Bank. Subsidiaries are included with their net earnings. This means that, in the part of the result attributable to Totalkredit, contribution margin income and expenditure with banks are included in connection with distribution and administration for the mortgage credit institution. In Nykredit Bank, the net result is also affected by the mortgage credit business and customer relations, e.g. value adjustments of interest rate swap agreements entered into to hedge customers' interest rate risk.
Source: Reports to the Danish FSA.

	2015	2016	2017	2018	2019	Change, 1 year	Change, 5 years
Balance sheet items	*DKK millions*					*%*	
Cash in hand and demand deposits with central banks	1,915	853	898	809	295	-63.57	-84.60
Receivables from credit institutions and central banks	731,966	793,107	851,461	844,379	1,099,373	30.20	50.19
Loans	2,652,662	2,720,556	2,819,304	2,883,600	2,991,737	3.75	12.78
Loans excl. repos	*2,652,662*	*2,720,556*	*2,819,304*	*2,883,600*	*2,991,737*	*3.75*	*12.78*
Bonds	199,649	204,058	205,372	167,003	211,208	26.47	5.79
Shares etc.	5,021	5,630	6,095	6,961	6,716	-3.52	33.75
Equity investments in associates	155	161	162	54	49	-9.80	-68.63
Equity investments in affiliates	36,251	39,303	47,360	49,851	59,260	18.88	63.47
Assets linked to pool schemes	-	-	-	-	-		
Intangible assets	220	202	201	257	307	19.50	39.60
Land and buildings	516	523	545	141	795	462.60	54.09
Other property, plant and equipment	218	166	112	113	159	40.23	-27.26
Tax assets	119	172	605	387	273	-29.58	129.57
Assets held temporarily	1,070	1,102	721	667	208	-68.85	-80.57
Other assets	17,154	14,976	12,594	10,174	12,379	21.68	-27.84
Accruals and deferred income	255	273	334	424	464	9.52	81.89
Total assets	**3,647,170**	**3,781,081**	**3,945,763**	**3,964,820**	**4,383,223**	10.55	20.18
Debts to credit institutions and central banks	665,453	676,904	711,303	727,340	857,165	17.85	28.81
Deposits	-	-	-	10,500	11,950	13.81	
Deposits excl. repos	-	-	-	-	-		
Issued bonds	2,749,817	2,859,033	2,971,770	2,970,099	3,248,851	9.39	18.15
Other liabilities	427	-	8,501	3	3	17.18	-99.24
Accruals and deferred income	26	45	39	26	36	40.29	41.68
Liabilities, total	***3,452,839***	***3,569,879***	***3,720,646***	***3,734,095***	***4,142,826***	***10.95***	***19.98***
Provisions	620	508	674	513	745	45.08	20.09
Subordinated debt	12,907	19,278	15,792	15,861	16,516	4.13	27.96
Equity	180,804	191,416	208,651	214,350	223,136	4.10	23.41
+Total liabilities	**3,647,170**	**3,781,081**	**3,945,763**	**3,964,820**	**4,383,223**	10.55	20.18

Note: The figures are based on the institutions that existed in the individual years. The table shows selected items. In 2019, the mortgage credit sector consisted of Nykredit Realkredit, Realkredit Danmark, Totalkredit, Jyske Realkredit, DLR Kredit, LR Realkredit and Nordea Kredit. In the profits from investments and equity, Totalkredit is a double entry due to it being part of the Nykredit Group. The profits from investments can mainly be attributed to subsidiaries in Nykredit Realkredit: Totalkredit and Nykredit Bank. Subsidiaries are included with their net earnings. This means that, in the part of the result attributable to Totalkredit, contribution margin income and expenditure with banks are included in connection with distribution and administration for the mortgage credit institution. In Nykredit Bank, the net result is also affected by the mortgage credit business and customer relations, e.g. value adjustments of interest rate swap agreements entered into to hedge customers' interest rate risk.
Source: Reports to the Danish FSA.

9. Annex 2: Mortgage credit institutions, financial ratios 2015–2019

	2015	2016	2017	2018	2019
Capital ratio (%)	23.09	23.57	23.46	23.66	22.87
Core capital ratio (%)	21.47	21.75	21.64	21.92	21.09
Actual core capital ratio (%)	20.92	20.72	20.80	21.09	20.31
Return on equity before tax (%)	8.07	9.85	10.18	8.61	9.73
Return on equity after tax (%)	6.36	8.09	8.54	7.22	8.25
Ratio of op. income to op. expenses (DKK)	2.62	3.35	4.08	4.16	4.19
Accumulated write-down rate (%)	0.44	0.43	0.38	0.36	0.34
Write-down percentage for the period (%)	0.08	0.04	0.03	0.04	0.04
Lending in relation to equity (ratio)	14.67	14.21	13.51	13.45	13.41
Total risk exposures (DKK bn)	815	864	909	929	1,003

Note: The table shows selected items. The figures are based on the institutions that existed in the individual years.
Source: Reports to the Danish FSA.