



REALKREDITRÅDET

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### **Danish Prepayment System**

This paper presents a description of the prepayment system used by the Danish Mortgage Banks. The purpose of the paper is to give a general overview, but also in order to present a system that actually meets all the requirements of a free competitive market, while at the same time offering a simple and transparent prepayment solution to the mortgage borrower – the consumer.

#### **The cornerstones of the Danish Mortgage finance system**

In Denmark the financing of real property primarily takes place via mortgage banks. The Danish mortgage credit market is based on the efficient and inexpensive provision of credit with the following characteristics:

- the borrower's real property is mortgaged as collateral for the loan;
- the loan is long-term, up to 30 years;
- loans are granted within the framework of the Mortgage Credit Act and ensuing legislation (executive orders issued by the Danish Financial Supervisory Authority);
- the loans are financed by the issue of mortgage bonds subject to the legally required Balance Principle regulating payment imbalances (as a result of this principle the only risk from the lending business is the credit risk);
- loan terms including interest rate and methods of prepayment are set with direct reference to the mortgage bonds issued to fund the loan;
- interest rates are marked-to-market and transparent.

Bond investors are informed of the bond collateral, the legislative framework and the solvency of the mortgage bank.

#### **Prepayment**

The borrower can prepay the loan at any time – partly or wholly.

If the borrower wants to prepay his/her loan the following issues are relevant to consider:

- Methods of prepayment
- Borrowers costs of prepayment

#### **Methods of prepayment**

Borrowers have one or two options depending on their choice of product.

*Delivery option – common for all loans – characteristics:*

When exercising the delivery option borrowers purchase bonds issued to fund the loan in an amount matching the outstanding debt of the loan at market price. In purchasing the bonds, borrowers may use the mortgage bank, a commercial or savings bank or a stock broker as intermediary. By delivering the bonds to the mortgage bank, the loan is prepaid.

Borrowers may exercise the delivery option at any time during the term of the loan, however, borrowers run the hypothetical risk of being unable to purchase the bonds in the market due market imperfections. In this scenario, the delivery option is not exercisable. To mitigate this risk, mortgage banks typically holds a portfolio of all bonds issued.

Mortgage banks do not suffer a loss when delivery options are exercised, all transactions being marked-to-market.

*Call option – additional option for mortgage loans based on callable bonds – characteristics:*

When exercising the call option the remaining debt of the bonds issued to fund the loan is prepaid at par on the next bond payment date 1 January, 1 April, 1 July or 1 October, however, borrowers must give two months notice before exercising the call option i.e. notification deadlines are 31 January, 30 April, 31 July or 30 October.

Borrowers may prepay at any given time, however, they will be charged coupon interest rates on bonds and receive a deposit rate in the period from prepayment of the loan until the next bond payment date on which bonds are prepaid.

To comply with the Balance Principle borrowers' call options must be embedded in bonds issued to fund the loan to achieve a perfect hedge i.e. mortgage banks may not assume any call risk.

When call options are exercised the bond holder will incur a loss equivalent to the market price of the bond minus par. The risk of incurring such a loss is reflected in the pricing of callable bonds. Market prices suggest that the yield to maturity of callable bonds exceed the yield to maturity of similar non callable bonds by 25bp to 75bp depending on the risk of the bond being called. This yield to maturity differential may be regarded a call premium awarded to the bond holder.

Callable loan interest rates are fixed based on the prevailing market pricing of callable bonds funding the loan i.e. the borrower is charged the call premium indirectly.

Callable loans account for approximately 50 per cent of total lending.

*Borrower costs of prepayment*

Borrowers' cost of prepayment is split into:

(1) Cost from purchasing/calling bonds that originally was sold to fund the loan. If the borrower exercises the call option the only payment is the nominal value of the outstanding debt. If the borrower exercises the delivery option he has to pay the market value of mortgage bonds issued. These are the market price for the bonds when purchasing the bonds at the Copenhagen Stock Exchange. Whether the transaction is handled by the mortgage bank or a commercial bank there is an additional cost for the handling and trading of the bonds. This amounts to approximately 0.25 per cent of the bonds bought.

(2) Fees to the mortgage bank. These are transaction fees fixed to reflect the transactions ordered by the borrower in the course of the prepayment procedure. Any prepayment procedure starts with a prepayment offer from the mortgage bank, making sure the borrower knows the costs and consequences of the prepayment. There is a fee of typically DKK 200 (EUR 27) on the prepayment offer. The mortgage bank charge a fee of DKK 750 (EUR 100) when making the actual transaction connected to the prepayment. In the Danish prepayment system no prepayment penalties are paid to the mortgage banks.

### **Prepayment regulation**

Costs from purchasing/calling bonds funding the loan

- Not recognised as a prepayment indemnity in the Danish legislation – it is regulated as a precondition in the loan offer and in the loan agreement how the loan might be prepaid. Thus the borrower can assess the prepayment situation before the loan agreement is closed.
- Market value of the bonds funding the loan must be fixed observing best practice guidelines. These guidelines are issued and supervised by the Financial Services Supervisory Board.

Fees

- Fees which are obviously unfair (i.e. disproportionate) are not allowed. This is also regulated in the best practise guidelines, and – more important – through fierce competition. The fees for default and the transactions handling default are regulated separately in the Terms and Conditions of Forced Sale issued under the Ministry of Justice.

Obligation to inform

- Fees and terms of prepayment are well described in the loan offer – this is regulated in the best practise guidelines.
- Best practice documentation.

### **Level of prepayments**

The prepayment option is a well known by the Danish mortgage borrowers and is used to benefit from changes in the interest rate level. The volume of prepayments of Danish mortgage loans has been high for several years. In 2004 approx. 20 per cent of all borrowers prepaid their mortgage loans to remortgage corresponding to approx. DKK 300bn DKK (EUR-equivalent 40bn).

## Summing up

The Danish mortgage system offers extensive prepayment possibilities for the borrower based on conditions known from the moment the loan is offered and at a price that is established marked-to-market. So:

- The borrower has a right to prepay at any time he so chooses.
- Any charge is calculated in an objective manner to reflect costs, e.g. prepayment is done at market price.
- And any charge is clearly indicated to the borrower.
- Borrowers are afforded the choice between callable loans and non callable loans. When choosing a callable loan the borrower's right to prepay is extended, however, the borrower must pay a call premium fixed marked-to-market. When choosing a non callable loan, borrowers' right to prepay as well as the interest rate is reduced.