Why the Danish mortgage bond market is sinking into negative yield territory

Part of the **Alternative View** series
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Over the past year, yields have continued to drop significantly in European fixed income markets. In many countries, in particular Denmark, mortgage rates have seen similar falls. In August, Nordea has issued a 20-year Danish mortgage bond at 0% while another mortgage bank, Jyske Bank, has even issued a 10-year mortgage bond at a negative rate of -0.5%. In this article, we explain what this means in practice and also make a comparison with investments in Dutch mortgage loans.

What are Danish mortgage bonds?

Danish mortgage bonds are coupled to residential mortgage loans and are mainly issued by specialized mortgage credit institutions such as Nordea Kredit, Realkredit Danmark, Nykredit, DLR Kredit and Jyske Realkredit. These institutions retain the credit risk on the loans they issue, but pass the interest rate and prepayment risk on to the bond holders. Ratings for Danish mortgage bonds are typically very high (most have a AAA rating) and a liquid secondary market exists, providing daily liquidity in practice.

Why are Danish mortgage bond yields currently so low?

Figure 1 shows that the Danish 10-year government bond yield has sharply decreased in the past year, leading to strongly negative interest rates at this moment. This is in line with declining yields on other European government bonds with the highest credit rating (AAA), like Germany or the Netherlands. The Danish central bank also uses negative interest rates as a method to limit capital inflows, in order to defend the currency peg of the Danish krone to the euro.

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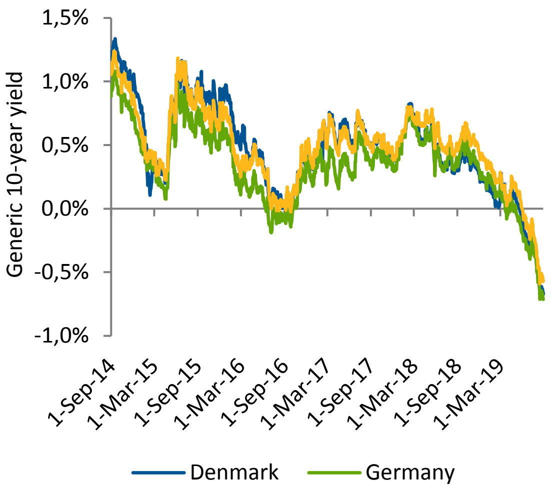
Figure 1: Yield development of 10-year government bonds



Source: Bloomberg, as of 29 August 2019.

Danish mortgage bonds are trading close to the Danish government bond curve due to their high rating (also AAA) and the high liquidity of this market. Due to the sharply decreasing Danish government bond yields, as shown in Figure 1, the yield on Danish mortgage bonds is now also dragged into negative territory.

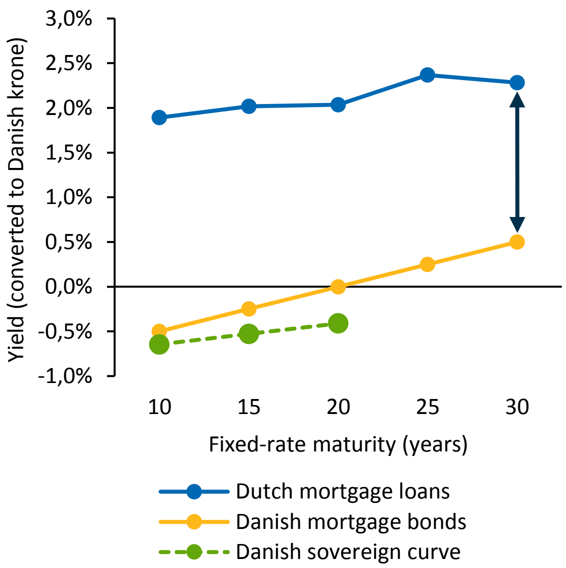
Are Danish house owners now receiving money on their mortgage?

Not really. First of all, borrowers also pay additional administration fees to their mortgage bank (which issues the mortgage bond). These administration fees typically range between 0.5% and 1.5%. This means that most Danish mortgage owners still have to pay money to their mortgage banks. Secondly, even if the net payment became negative, a commonly used method is that the mortgage bank uses the negative payment to reduce the scheduled repayment of the mortgage. If this still leads to a negative payment, another option is that an additional prepayment takes place. So, in practice (strongly) negative mortgage rates will lead to a faster repayment of the underlying mortgages.

How does this compare to Dutch mortgage loans?

Figure 2 shows that Danish mortgage bonds currently only offer a small spread over Danish government bonds (between 0.14% at 10 year and 0.41% at 30 year). However, the current yields on Dutch mortgages are much higher: the difference with Danish mortgage bonds is between 1.8% and 2.4%, depending on the maturity.

Figure 2: Comparison of the yields on Danish mortgage bonds and Dutch mortgage loans



Source: Bloomberg, Aegon Asset Management, as of 29 August 2019. We here take the perspective of a Danish investor who has hedged the currency risk of euro-denominated Dutch mortgage loans. Dutch mortgage loan yields are based on Aegon mortgage rates. We assume that 25% of the Dutch mortgages are backed up by a Dutch State guarantee (NHG). For the remaining 75% we assume that the loan-to-value (LTV) is higher than 81%. Yields for Danish mortgage bonds have been based on recent quotes for mortgage bonds: 10 year at -0.5% (Jyske Bank), 20 year at 0% (Nordea) and 30 year at 0.5% (Nordea and Realkredit Danmark).

This large difference is mainly caused by two factors:

- *Different degree of liquidity*: Danish mortgage bonds are traded in a highly liquid market whereas Dutch mortgage loans cannot be traded on an active secondary market. Dutch mortgage loans thus benefit from a significant illiquidity premium. This effect is enhanced by the limited number of parties originating Dutch mortgage loans and the segmentation of this market with banks focusing on the shorter maturities and insurance companies and pension funds aiming at the longer maturities.

- *Different rating*: Danish mortgage bonds typically have a AAA rating. This is higher than Dutch mortgage loans, which typically have an (equivalent) rating of approximately AA. Therefore, Dutch mortgage loans have an additional credit risk premium.

Other elements also play a role, such as a different regulatory treatment, the availability of a government guarantee for Dutch mortgages and a different treatment of early prepayments in Denmark and the Netherlands. For more background, see the article A look across the border by David van Bragt.

Table 1 summarizes the main characteristics of Danish and Dutch mortgage investments.

Conclusions

Danish mortgage bonds have recently entered into negative territory, in the wake of sharply decreasing Danish sovereign yields. These mortgage bonds are traditionally an attractive alternative to Danish government bonds (higher yield, high liquidity, low capital charge). For investors who allocate part of their assets to illiquid categories, Dutch mortgages can however offer a significant additional spread compared to Danish mortgage bonds.

Table 1: Comparison of Danish mortgage bonds and Dutch mortgage loans

Criteria	Danish mortgage bonds	Dutch mortgage loans
Yield	+/-	+
Liquidity	++	–
Required capital under Solvency II	+	++
Interest rate hedging	–	+
Government guarantee possibility	–	+
Currency	Danish krone	euro

Source: Aegon Asset Management, as of 29 August 2019.

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