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Increasing competition in the Dutch mortgage market

Which mortgage for which investor?

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With Dutch pension funds increasingly investing in Dutch mortgages, the mortgage market now has three important groups of mortgage lenders: banks, pension funds and insurers. It has always been common practice for banks to provide mortgages, but because of the credit crunch and the subsequent changes in legislation, this service is under discussion. Suddenly it is important to seriously consider whether providing mortgages still aligns with the business model, and if so, which mortgages are suitable.

Over the last few years we have already seen, for example, that banks are focussing more on mortgages with shorter fixed-interest periods and a lower loan compared to the value of the property, or loan-to-value (LTV). Directly investing in the mortgage market is a relatively new phenomenon for pension funds; they focus on loans with a relatively long fixed-interest period. As with pension funds, insurers have also become more actively involved in investing in mortgages over the last few years. Many insurers focus on mortgages with a National Mortgage Guarantee (NHG), which contain generally less risk. Because of tightened European legislation, it are precisely these government-guaranteed mortgages that are less interesting to insurers.

There is indeed a great deal of movement in the mortgage market. There are new investors, new regulations and new business models. But which type of mortgage suits which investor? That is determined by the investor's finance strategy and the solvability requirements for credit risk under the standard model of the corresponding supervisory framework.

Banks

Banks mainly finance mortgage loans with short-term money; for example, with money customers have on their current or savings accounts, the largest part of which is freely available. Figures from the CBS show that in November 2015 85% (288 billion euros) of the Dutch savings deposited with banks was without fixed duration. The money is also financed via the capital market or through provision of covered bonds or residential mortgage-backed securities. Banks often choose for the short term, for which the interest is lower than with long term.

The solvability requirements for banks are set down in Basel III and consist of three pillars: 1. Minimum capital requirements, 2. Supervisory review, 3. Market discipline.

In order to determine the required solvability, all assets are expressed as risk-weighted assets (RWA). Under the current standardized approach, the RWA for a mortgage with an LTV up to 80% is equal to 35% and 75% for higher LTVs. The amount of regulatory required capital is determined by multiplying the RWA by the so-called BIS ratio. This is fixed by the Bank for International Settlements (BIS). This ratio depends among other things on the bank's systemic importance, the capital conservation buffer and the countercyclical capital buffer. For a major Dutch bank the BIS ratio is 11 to 16 percent.

The BIS is working on a revised standardized approach. In the most recent version, published in December 2015, the RWA depends on the LTV. The RWA begins at 25% for mortgages with an LTV up to 40% and increases to 75% for an LTV above 100%. For the time being it looks as if RWA determination for mortgages benefiting from government guarantee (NHG) is also based on the LTV.

From the finance strategy perspective, a relatively short fixed-interest period is desirable for banks, and from the solvability requirements the lower LTV classes are desirable. Most banks work with their own models to determine the solvability, whereby less capital needs to be held than under the standard model; for example, for mortgages with NHG. However, the BIS is looking into whether the revised standard model can be used as a capital floor for the internal model, which could render NHG mortgages less attractive.

Insurers

Among insurers, it are mainly life insurers that provide mortgage funding. These insurers receive monthly premiums from their customers. These premiums are used to make payment in case a particular event occurs in the future. Insurers' money therefore has a long-term character.

The solvability requirements for insurers have been laid out in Solvency ll since 1 January 2016. This is made up of the same three pillar structure as Basel lll. Under the standard model the Solvency capital to be held is sub-divided into different modules depending on the type of risk. Mortgages fall under the module "Basic Solvency Capital Requirement" – default risk – type 2 exposures.

The formulas for calculating the Basic Solvency Capital Requirement and default risk contain various correlation factors. This ensures that if the risks are spread over different modules, the capital to be held is lower than if everything were included in one module. This is also called diversification.

For a few years, separate rules applied to loans with NHG, but these are not included in Solvency ll. As a result, only the LTV is still important. For mortgages with an LTV of up to 75%, type 2 exposure is equal to zero. Above this LTV the type 2 exposure increases linearly to 4.1% for an LTV of 102%. Regardless of the diversity of the portfolio, insurers therefore do not have to hold any capital for credit risk for mortgages with an LTV up to 75%.

Mortgages with a longer fixed-interest period are well suited because of the long-term obligations of the received premiums. Whereas banks have generally developed an internal model, insurers rely for the most part on the standard model that Solvency ll prescribes, making mortgages with a lower LTV more desirable for them.

Pension funds

Pension funds, like life insurers, receive premiums in return for obligations that have to be met in the future. These obligations often lie further in the future than those of insurers.

The new Financial Assessment Framework determines the required capital for pension funds. The standard model defines ten different risk categories. These are correlated, whereby a diversification factor is also present for pension funds. As a result, the composition of the whole portfolio influences the capital to be held.

The credit risk on mortgages is determined by the rating classes: AAA, AA, etc. One possibility is to determine it at portfolio level. Important factors for determining the rating classes of a mortgage portfolio are the LTV and the loan-to-income (LTI), the LTI particularly being a key factor. The lower the rating class, the more capital that needs to be held. The tested portfolio required a held capital of 4.8% for loans with an LTV smaller than 60%, and 6.0% for loans larger than 90%. No account was taken of the diversification factor, which is still applicable afterwards.

Because of the long-term of the resources entrusted to them, it is interesting for pension funds to invest in mortgages with a relatively long fixed-interest period. The lower LTV classes do require a lower held capital, but the relative difference with other assets is minimal. The extra interest margin for mortgages with a maximum LTV therefore makes these classes interesting for pension funds.

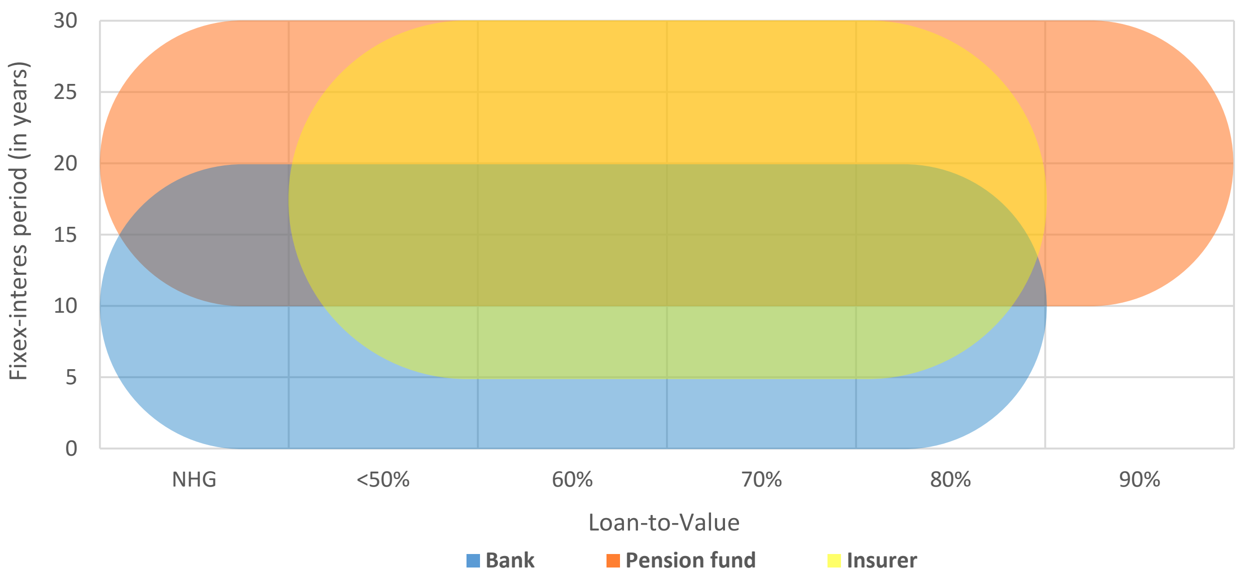
Comparison

With the arrival of pension funds, competition in the mortgage market has increased even further. In regard to financing and solvability requirements, a broad spectrum of mortgages is interesting to every group of investors. Which these are, are shown in Figure 1. A large part of the spectrum – the middle range LVT and medium fixed-interest period – is interesting to all three investment groups.

Banks mainly have access to short-term money, which makes mortgages with a short to medium length fixed-interest period attractive. From the solvability requirement perspective, mortgages with a lower LTV are preferred. Although the revised standard model does not take NHG into account, mortgages NHG are for the time being still attractive to banks. That is because most banks calculate the solvability requirement with an internal model in which mortgages with NHG generally have lower solvability requirements than the standard model.

Insurers have access to long-term money, making mortgages with a longer fixed-interest period suitable. Mortgages with a low LTV are interesting from the solvability requirements perspective, for which little to no capital needs to be held.

Figure 1. Preferred mortgages at banks, insurers and pension funds based on their business models and the corresponding supervisory frameworks.



Insurers have focussed mainly on NHG mortgages over the last few years, but these have become less interesting because of the current solvability requirements.

As with insurers, a longer fixed-interest period is desirable for pension funds because of the long-term money. The solvability requirements increase as the LTV gets higher. But the relative difference between the solvability requirements for an LTV smaller than 60% and larger than 90% is not as big as that for insurers and banks.

Mortgages with a high LTV are attractive to pension funds because of the higher interest margins. From 2018 the legal maximum LTV will be lowered to 100%, reducing the size of the distinctive value a little compared to banks and insurers.

In short, it is important for investors to carefully consider which mortgage best suits them. It is already necessary, but that necessity will increase as even more parties engage in the mortgage market. New groups of investors must not be excluded.

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DMFCO is an independent asset manager that offers institutional investors the opportunity to directly invest in Dutch home mortgages. DMFCO has very successfully launched the MUNT Mortgages brand into the Dutch market. For more information visit: www.dmfco.nl.