Investor Thinking

Sept 17

WHERE THE CLOCK TICKS: THE DUTCH RESIDENTIAL MORTGAGE MARKET

- In the Netherlands, the spread of mortgage rates over government bonds, their long duration, low default rates and low capital charge has attracted new, long-term institutional investors to the market.
- These characteristics may make Dutch mortgages attractive for incorporation in a liability matching portfolio, depending on an investor's objectives and regulatory framework.
- Investors beyond the Netherlands and the Eurozone, seeking to match their long-term liabilities, may also benefit from incorporating Dutch mortgages into their portfolios even after taking currency hedging into consideration.

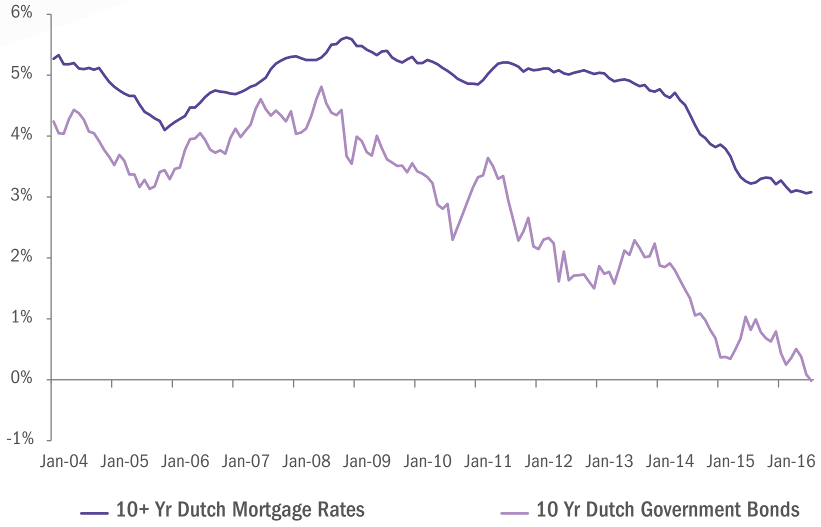
According to a Dutch saying, "The clock ticks at home, as it ticks nowhere else." Over the past years, Dutch institutional investors have become attuned to the workings of the Dutch mortgage market along with, more recently, investors from outside the Netherlands. Non-bank lenders have quickly seized the investment opportunity afforded by mortgages in the Netherlands, which could be advantageous in a liability driven investment framework owing to their long duration and the yield pick-up versus government bonds—in absolute terms or relative to capital charges. Amidst the iconic windmills, sit predominantly prime assets against a backdrop of a low rate of credit incidents[1] and a creditor-friendly legal environment. In this article, we weigh the pros and cons of Dutch residential mortgages from an institutional investor's perspective.

The Dutch residential mortgage market stands at roughly €650bn and is expected to reach up to €875bn by 2025[2] owing to a strong dynamic in new loan origination[3]. This market has been transformed in the span of a few years. Domestic deposits of €389bn are insufficient to finance this debt, leaving a funding gap exceeding €260bn in 2015[4]. Recently, new non-bank lenders have entered the market, drawn to the yield pick-up Dutch mortgages offer versus Dutch government bonds (Figure 1). According to Ortec Finance, a technology and advisory services provider, "Government paper has become less attractive as a hedging instrument because of declining yields. As a result, institutional investors are partly replacing Dutch government bonds with mortgage investments"[5].

1 Source: Moody's as of December 2016. Lowest rate in main European markets of arrears over 90 days across prime RMBS indices. For illustrative purposes only. The figures relate to previous months or years and past performance is not a reliable indicator of current or future performance.
2 Source: Kames Capital and Dutch Central Bank –November 2016
3 Source: Kadaster, Dynamic Credit. New loan originations amounted to nearly €81bn in 2016
4 Source: AXA IM, Aegon as of December 2016
5 Source: Ortec Finance, IPE Magazine, June 2016. The Netherlands: Managing, not matching.

AXA INVESTMENT MANAGERS

Figure 1: Dutch mortgage rates versus margin over Dutch government bonds



Source: ECB, Bloomberg as of December 2016. For illustrative purposes only. The figures provided relate to previous months or years and past performance is not a reliable indicator of current or future performance.

"Dutch mortgages offer long-term investors attractive yields versus Dutch government bonds."

The entrance of insurers and pension funds has provided a complementary source of funding to the market, and these players now account for around one-third of new loans and one-quarter of outstanding mortgages[6]. At the same time, the Dutch banks' market share of new loans fell from c. 80% in 2006-2007 to less than 60% in 2015-2016, further illustrating the diversification of the investor base[7].

Figure 1 shows a positive spread of mortgage rates over government bond yields, driven largely by the bank deposit funding gap (as mentioned earlier) and Dutch banks' need to source most of their refinancing for long-term mortgages from financial markets (unlike the case in Germany or France). In fact, spreads which widened between 2008 and 2011 are currently close to their widest historical levels because higher liquidity and capital requirements have made it more expensive for banks to keep mortgages with long maturities and high loan-to-value (LTV) levels on their balance sheets. For the foreseeable future, the size and long-term nature of the funding gap can be seen as a driver of sustainable spread levels, independent of the creditworthiness of the asset class.

6 Source: Land Registry and IG&H Consulting
7 Source: IG&H Consulting

Mortgage landscape

The Dutch mortgage market is mainly comprised of fixed rate loans. It is predominantly of prime quality, which means that borrowers do not have documented credit issues and properties are usually owner-occupied. A Code of Conduct that governs mortgage lending practices is designed to emphasise price and service competition along with affordability.

Slightly less than half of new mortgages, and particularly those with high LTV levels[8], benefit from the Nationale Hypotheke Garantie (NHG)[9]—a guarantee provided by the Foundation of the Guarantee Fund for Homeownership, which is backed by the Dutch State. As part of the NHG programme, loans fulfilling certain conditions, in exchange for a 1% up-front premium, may receive a guarantee and be offered a c.50bps discount on interest rate compared to standard mortgages with high loan-to-value. For lenders, the lower interest rate can be rationalised by the guarantee: the NHG covers 90% of the outstanding principal losses, accrued unpaid interest up to two years and disposal costs (after default and foreclosure) in case of an unforeseen life event.

At the time of writing, the foundation, which acts as guarantor, has sufficient capital to cover over 20 times the mean level of losses over the past seven years[10]. The Dutch Central Bank considers the NHG a Dutch state guarantee and the foundation benefits from the same credit rating as the Dutch State[11].

Main benefits for institutional investors

Alongside asset classes such as UK long lease and infrastructure debt, Dutch mortgages have a demonstrable track record of delivering steady cash flows for more than 20 years[12]. They offer a 190 basis point spread above government bonds as at 13/07/2017 while displaying low historic credit risk[13]. As such, they can play a significant role in an institutional investor's liability matching portfolio.

Dutch mortgages can offer credit diversification as the underlying risk is linked to individuals rather than corporates or government—the latter being a key component of many fixed income portfolios.

Finally, while the capital charge treatment of Dutch mortgages varies according to an investor's regulatory framework, it is generally benign for this asset class.

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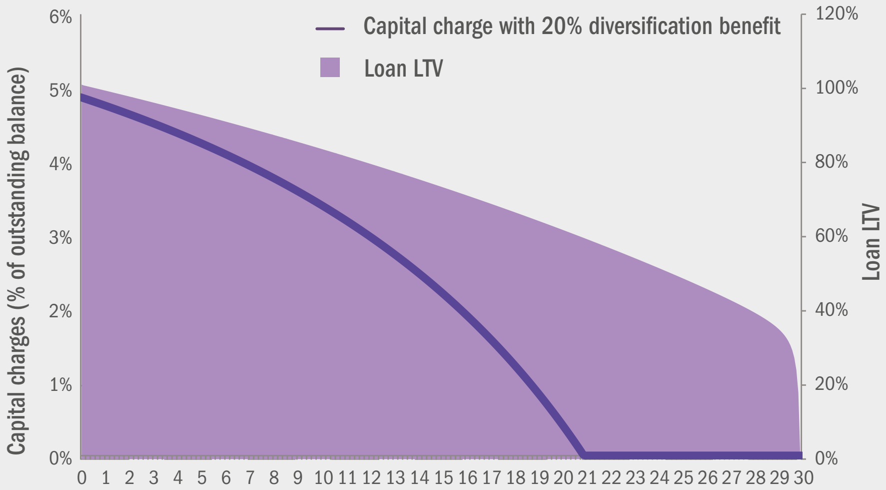
8 Source: De Nederlandsche Bank, 2015. Dutch mortgages in the DNB loan level data.
9 Source: ABN, WEW Q4 2016
10 Source: NHG
11 Source: AAA Moody's as of June 2017
12 Source: Moody's Residential Mortgages Backed Securities, IPD UK Long Lease
13 Source: Fitch Netherlands mortgage market index Q4 2016. For illustrative purposes only. The figures provided relate to previous months or years and past performance is not a reliable indicator of current or future performance.

Capital charge in a Solvency II framework

Mortgages are typically classified as Type 2 of the basic module of Solvency Capital Requirement (SCR) for counterparty default risk and are not subject to spread risk. Stemming from the fact that the risks are spread over different modules, these exposures contain correlation factors that can further lower the capital charge.

Based on a conservative set of assumptions, including 65% amortising and 35% interest-only mortgages, no prepayment and constant house prices[14], the capital charge would average 2.1% over 30 years[15]. Due to amortisation over the lifetime of a mortgage, the SCR starts higher – typically at 5% – and diminishes to zero after 21 years as illustrated in Figure 2.

Figure 2: Portfolio capital charge decreases over time with the amortising loan component



Source: AXA IM as of June 2017. For illustrative purposes only. The calculation of the Solvency Capital Charge estimate is based upon a specific assumption set.

14 Maximum level authorised by the Dutch code of conduct in 2017
15 SCR formula as of June 2017: 15% x max (0; loan value – 80% x Loan value/LTV) for performing loans; for loans that have been delinquent for over 3 months, the 15% is replaced by 90%. This value can be lowered by a diversification effect; typically 20%.

Considerations when investing in Dutch mortgages

It is important for investors contemplating adding Dutch mortgages to their portfolio to carefully weigh the benefits against the potential risks. Although it is hard to create an exhaustive list – some of these are discussed below. The risks could be mitigated by performing thorough due diligence while investing but also with continuous monitoring over the term of the investment.

Arrears

Late payments may negatively impact cash flows, although the Dutch market is better positioned in this respect than other European markets. Looking across a series of European prime residential mortgage backed security (RMBS) indices over the past 12 years, the Netherlands tends to have the lowest rate of arrears above 90 days—currently less than 0.5% of outstanding residential mortgage debt[16]. Coaching programmes, particularly for NHG-backed borrowers, have been set up to assist homeowners to put their finances in order and avoid foreclosure. Similarly, the country offers a generous social security system that helps protect borrowers in the case of unemployment. To mitigate the impact of arrears, a strict affordability test is required for new loans[17]. In addition, lenders have full recourse through the legal system.

Default and disposal

Defaults of Dutch mortgages can occur, although they are relatively rare and their impact has been very limited with a realised loss ratio capped at 0.15% over the last 10 years[18]. Lenders have the right to repossess properties without a court order – a process that takes 15 months on average – and a borrower's salary can be attached via a bailiff. Only in very rare cases of a five-year bankruptcy can a borrower be relieved of their debt, a determination subject to strict regulation and a court order. Deterioration in macroeconomic conditions and a decline in housing market values such as the period from 2008 to 2013, when prices fell 22% peak to trough[19], are possible and could exacerbate losses. It is worth noting that since then, enhancements in the Dutch code of conduct governing mortgage lending processes have been implemented to help reduce the potential gap between the dwelling value and the default amount (for example the maximum LTV at loan origination is capped at around 100%[20] and the interest-only portion of a loan is restricted to a maximum of 50% of a property's value etc.).

"Looking across a series of European prime residential mortgage backed security (RMBS) indices over the past 12 years, the Netherlands tends to have the lowest rate of arrears above 90 days."

16 Source: Moody's as of December 2016. RMBS: Residential Mortgages Backed Securities. For illustrative purposes only. The figures provided relate to previous months or years and past performance is not a reliable indicator of current or future performance.

17 On average 16% of the net income of first-time homeowner is spent on housing costs in 2016 vs 25% to 30% pre-crisis before this test was required– Source Calcasa – 2016. For illustrative purposes only. The figures provided relate to previous months or years and past performance is not a reliable indicator of current or future performance.

18 Source: Fitch Netherlands mortgage market index Q4 2016. For illustrative purposes only. The figures provided relate to previous months or years and past performance is not a reliable indicator of current or future performance.

19 Source: CBS Netherlands as of June 2017

20 Maximum LTV permitted at origination has been reduced from 106% in 2013 to 101% in 2017 and 100% in 2018 and beyond. Although still above average European standards, the current LTV levels at origination are lower than those levels permitted historically that sustained the limited realised loses mentioned previously through the global financial crisis, owing to several structural factors such as a creditor friendly environment, buffers provided by the social security system, etc.

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Prepayment risk

Lenders benefit from prepayment protection in the Netherlands. In the case of refinancing via a new lender, the prepayment penalty covers the present value of the loss of interest income. Prepayments free of penalty are limited to certain cases such as relocation or partial prepayments of 10% to 20% per year with the borrower's own funds. By purchasing loans at par - which is typical for newly originated loans - investors can mitigate uncompensated loss of interest income.

In the current, low-yield environment, prepayment rates are stable at around 8%[21] —although according to our calculations an investor's return is rather insensitive to prepayment. If the constant prepayment rate were to double to 16%, the net Internal Rate of Return (IRR) would decline by around 5 bps[22].

Interest rate reset risk

For some mortgages, the interest rate will be reset at the end of an initial fixed period. This is called the interest reset date. At this date, the lender has to offer a new rate to the borrower, which has to be equal to the rate being offered to new customers for a similar mortgage. The rate offered at reset has a direct impact on the interest payments to investors. Greater competition in the mortgage market at reset could potentially endanger the level of spread (over government bonds) that these mortgages command at origination. The later the reset date the lower the downside risk on the net IRR.

Given the low interest rate environment borrowers increasingly opt for fixed rate loans with reset dates that are 20 or more years away (whereas 5 or 10 years was common in the past). Nevertheless careful attention should be paid to the reset date when selecting Dutch mortgages. It is also important to negotiate terms to help protect investors from financial institutions allowing the borrowers a low reset rate leading to an insufficient margin at reset.

Liquidity

A long-term horizon is required for this kind of investment as liquidity of a portfolio of residential mortgages is the exception rather than the norm. When access is structured through a security note[23], transferability to other investors is possible, although this is very limited in practice.

Operational and misalignment risks

Investors need to be confident that loans have been originated properly and are serviced in their best interest. For instance the final loss of a defaulted loan can be worsened by poor servicing practice or the NHG guarantee can be affected by underwriting or servicing errors[24].

Investors should be mindful of the risk of misalignment of interests that an originate-to-distribute model presents. Certain lenders that

21 Source: Moody's Dutch Prime RMBS Index, Q4 2016 (100% NHG). For illustrative purposes only. The figures provided relate to previous months or years and past performance is not a reliable indicator of current or future performance.
22 Source: AXA IM. For illustrative purposes only. The calculation of the IRR is based upon a specific assumption set of a base case scenario including a 0.5% annual default rate on a 100% NHG investment.
23 We exclude in this paper covered bonds which offer only conditional exposition to the Dutch mortgages when the issuer, usually a financial institution, defaults.
24 A discount of up to 18% in the NHG guarantee has been observed in cases of poor quality of the origination or the servicing.

distribute loans to institutional investors tend not to retain credit exposure, preferring to transfer all risks to investors. To achieve an alignment of interests among all parties, additional protective rights can be introduced to help strengthen the investor's protection with regard to underwriting and servicing. For example, some products differentiate themselves by introducing covenants that ensure that the lender does retain some risk and remains committed to careful borrower selection. These protective rights require ongoing portfolio monitoring and real powers for investors to act in case of adverse events.

Accounting and valuation considerations

The accounting valuation applied to Dutch mortgage holdings could introduce volatility to an investor's balance sheet or capital adequacy measures. Certain mortgage investment vehicles are exposed to mark-to-market valuations and subject to interest rate and spread risks while others also allow for amortised cost accounting[25] which mitigates these risks. The choice of accounting method can serve to reduce the volatility of the P&L or of the funding/solvency ratio.

Considerations for non-Dutch investors

For non-Dutch Eurozone investors, the benefits to be achieved by investing in Dutch mortgages may be better appreciated by comparing their spreads versus the yield of their own government bonds, and to the risks specific to the asset class detailed previously.

Non-Eurozone investors would probably need to think about currency hedging. For example, a UK or US investor could receive a 240-260 bps spread after currency hedging vis-à-vis their own government bonds[26].

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Conclusion

The residential loan market in the Netherlands offers distinctive characteristics with the yield pick-up versus government bonds, either in absolute terms or relative to capital charges and the historical low default rate. As an asset class, these loans also constitute a durable investment opportunity owing to their long duration.

Alongside suitable accounting and valuation treatment, it is important as with any investment, to assess the risks and ensure risk mitigation measures are undertaken, especially against the risk of misalignment of interests resulting from the originate-to-distribute model.

Given the distinctive return and duration characteristics of the asset class, and the sizeable funding gap in the market, the Dutch mortgage landscape looks set to continue to offer an attractive investment opportunity for those long-term institutional investors looking to further diversify their sources of yield whilst meeting their liability matching requirements.

25 "Loan and receivable" section in IFRS9
26 Sources: Moody's Dutch RMBS index, Bloomberg, AXA IM in the market conditions of 13/07/2017. For illustrative purposes only. The figures provided relate to previous months or years and past performance is not a reliable indicator of current or future performance.

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