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Is there a level playing field in the Dutch market of Residential Mortgages?

To avoid cross-sector arbitrage, the European Commission has announced its intentions to "align" capital requirements for mortgages for insurers under the Solvency II regime with banks under the Basel III regime.

This article provides further background to this discussion and also shows that there are various business characteristics and principles underlying the regulatory capital frameworks that disrupt a level playing field between insurers and banks.

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DEVELOPMENTS IN THE MORTGAGE MARKET

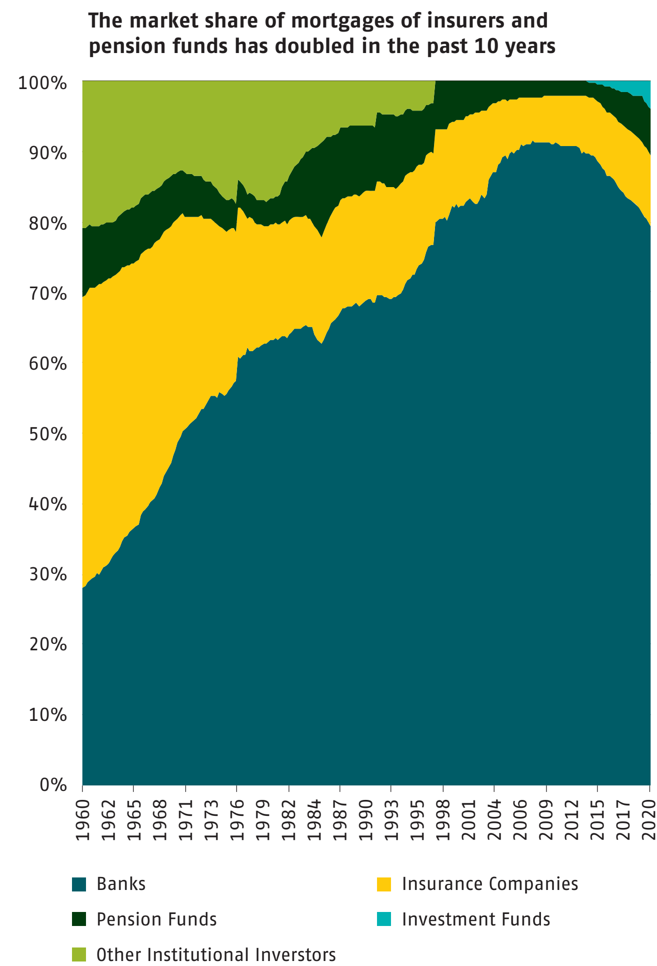
The share of banks in the Dutch mortgage market is declining

For more than 50 years, banks had an ever increasing share in the Dutch mortgage market. However, this trend has shifted in favor of insurers (growth of 50% in past decade), pension funds (growth of 200% in past decade) and investment funds. See Figure 1.

The two main reasons for the changing trend are as follows:

1. *The low and flat yield curve*; Long-term interest rates have fallen sharply in de past years. Because insurers and pension funds naturally have long-term obligations, it is more attractive for them than for banks to offer competitive mortgage interest rates. The search for yield has resulted in a doubling of the share of mortgages on the balance sheet of insurance companies. See Figure 2.

2. *The differences in capital requirements between mortgage providers.* Over the past 10 years, there has been a trend that capital requirements for banks are (implicitly) increasing (e.g. increasing supervision of self-developed capital models at banks leading to extra capital add-ons (implicit), as well as newly introduced RWA[1] floor in the Netherlands due to assumed increased systematic risk).



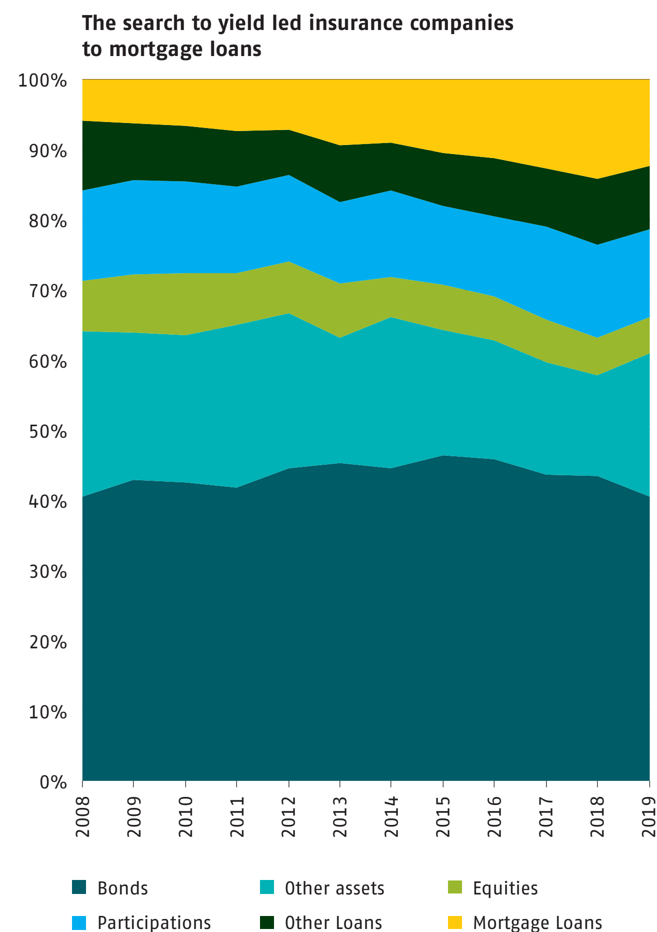


Figure 1+2: Market share of mortgages of Insurers and Pension Funds is doubles due to the search to yield

INTENTION OF EC TO ALIGN PRUDENTIAL TREATMENT OF MORTGAGES

Insurance companies have argued that alignment of capital requirements for mortgage loans between banks and insurance companies is not justified

Lately, the European Commission ('EC') has announced the intention to align the calibration of the capital requirements for mortgages under Solvency II with the Basel (III/IV) credit risk framework of the banking sector. The EC's stated aim is "to avoid any risk of cross-sector regulatory arbitrage".

According to Insurance companies (represented by Insurance Europe), the EC's stated intention to "align" the capital requirements is not justified based on different arguments:

Item	Argumentation
Differences in business models and funding models of insurers versus banks	– Business model banks: Use mortgage loans to generate interest income as part of maturity transformation of short-term liabilities into long-term assets. – Business model insurance: Use cash flows of mortgage loans to cover long-term insurance liabilities cash flows.
Valuation of mortgages differs among banking and insurance frameworks	Under Solvency II, assets and liabilities are valued at their economic (market) value and not at "impairment adjusted" amortized cost value as per the banking regime. An alignment of the prudential treatment of mortgages would not be in line with the Solvency II principles.
No thorough impact assessment has taken place yet	Thorough impact assessment would be needed to support any change in treatment of mortgage loans under insurance regulation.
European mortgage market is diverse	The mortgage market in Europe is very diverse. Significant differences exist amongst the different countries, for which further analysis of different characteristics would be needed.

CAPITAL REQUIREMENTS FOR MORTGAGE LOANS

Banks (Basel III regime)

Under the Basel framework, the available capital ("total capital") is predominantly derived as the sum of market risk, credit risk and operational risk without taking diversification into account. Capital requirements are normally reflected in terms of Risk Weighted Assets, derived by multiplying the capital requirements for market risk, credit risk and operational risk by 12.5 (i.e. being the reciprocal of the minimum capital ratio of 8%). Since no diversification is allowed by banks between the risk types in their regulatory capital, the impact of an increase of capital related to credit risk has an 1 to 1 impact on the total capital required.

Banks can either use the Standardized Approach (SA) for their Capital Requirements or develop their Internal Models and use them to calculate the required capital, but the requirements for Internal Models have become far more strict in the past 5 years to get or keep the "Advanced Internal Ratings Based (IRB) Approach" – status.

Insurance companies (Solvency II regime)

Under Solvency II, the available capital ("eligible own funds") is defined based on an economic value or fair value basis. The required capital ("required SCR") can be derived using the Standard Formula or using Internal Models. The conditions to apply an internal model are severe and only a limited amount of large insurance companies apply partial internal models (i.e. NN Group, Aegon and Achmea). The use of the Standard Formula is based on the aggregated outcome of capital requirements related to six different underlying risk modules[2]. Different levels of diversification are taken into account: both within the different risk modules as well as between different risk modules.

On top of this companies are – subject to the performance of a recoverability assessment – allowed to lower their capital requirement with a tax adjustment (the Loss Absorbing Capacity of Deferred Taxes or LACDT). The solvency capital requirement for counterparty default risk is calculated as a certain percentage of the LGD, depending on the risk type. In case of residential mortgages, the LGD is defined as the value of the mortgage loan minus the maximum of 80% of the risk-adjusted value of the residential property, and the guarantee. The risk-adjusted value of the residential property equals 75% of the property's market value.

The Solvency II framework does not contain additional liquidity buffer requirements or a required leverage ratio as prescribed within the Basel III framework.

Pension Funds

Pension Funds are subject to the Pensions Act, regulated by the Financieel Toetsingskader (FTK) and can be viewed as a rather simplistic version of Solvency II.

COMPARISON MORTGAGE CAPITAL REQUIREMENTS

We compared the Basel III capital requirement (banks) with the standalone capital requirement for mortgage loans under Solvency II (insurance companies):

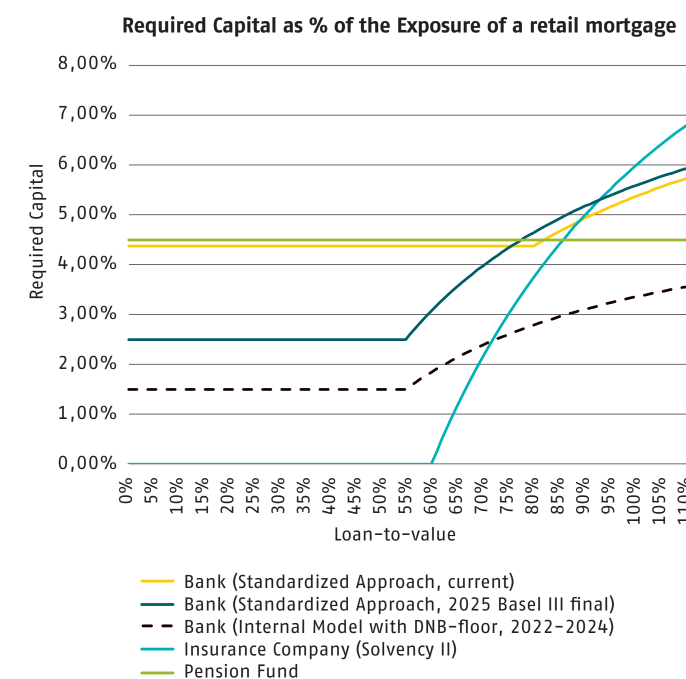


Figure 3: Required Capital for retail mortgages across prudential regimes in 2022

Based on the results in Figure 3, it can be concluded that the capital requirements for a comparable residential mortgage loan can vary between the different prudential frameworks. Depending on the duration of the cash flows, Pension Funds seems to have the (relative) highest required capital for mortgages, before diversification[3]. Insurance companies are facing the lowest capital requirements, even before diversification. Note, that the differences are relatively small in the LTV range of 75%-100% where the biggest exposure of newly originated mortgage loans is concentrated.

Another point of attention is that the mortgage capital requirements for insurance companies under Solvency II decrease very sharply for LTV values of 80% or lower. For LTV values below 60%, the capital requirements even become nihil. This is not realistic, since this would imply that there is no credit risk at all, while in reality there is material credit risk exposure even for low LTV loans.

Besides a comparison between the prudential frameworks, it is also relevant to consider the level of capitalization. The most important measure to express the degree of capitalization of a bank is the Common Equity Tier 1 ratio (CET1 ratio). A bank's tier 1 capital ratio is calculated by dividing its tier 1 capital by its total risk-weighted assets. It is common for insurers to assess capitalization on the basis of the solvency ratio. The implied CET1 ratio for insurers can by calculated by multiplying 8% by unrestricted tier 1 capital divided by the required solvency capital requirement.

Based on a survey performed by us at year-end 2021 we found that the CET1 ratio held for larger Dutch and European banks is 16% or higher whereas the major European insurance groups have a relatively lower implied CET1 ratio in the range of 10%-13%. It can be concluded from this that the level of capitalization in relation to regulatory capital is on average higher for European banks than for European insurers.

So even if the European Commission manage to equalize the regulatory required capital for mortgage credit risk, the question is whether the overall objective will be successful in creating a level playing field. ■

1 – RWA = Risk Weighted Assets

2 – Market risk, counterparty default risk, life underwriting risk, non-life underwriting risk, health underwriting risk, operational risk

3 – Assuming a duration for the mortgage portfolio of 9.3 years, the capital requirements amount to roughly 4.5% without diversification.

"Equal capital requirements for mortgages does not result in a level playing field"

We strongly supports the intention of the European Commission to harmonize capital requirements for mortgages between sectors. However:

- This will not be achieved by simply aligning the capital requirements for mortgages. As long as the fundamental differences in the prudential frameworks and market discipline exist, it is not realistic to achieve a level playing field. The most important differences are:
  - Insurers can diversify between risk types and expected future tax benefits are allowed, banks cannot.
  - Banks have to deal with a minimum floor across all their internal models as of 2022.
  - Valuation of mortgages differs materially between the different prudential frameworks
  - The degree of capitalization in relation to regulatory requirements differs among banks and insurers.
- In order to create a truly level playing field, Pension Funds will also have to be involved in this solution. Partly due to the low (long-term) interest rates, the share of pension funds in the mortgage market has increased in recent years.

This does not alter the fact that the extremes in current requirements, such as the lack of capital requirements for insurers with respect to mortgages with an Loan-To-Value below 60%, should be removed.