Redefining liquidity in Dutch residential mortgage investments

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Introduction

Amidst global economic shifts and policy changes, the rapid rise in interest rates has increased the focus on liquidity for institutional investors. Dutch residential mortgages have traditionally been viewed as an illiquid asset class, not dissimilar to other private credit assets. In this article we will explore that the asset class possesses some unique features which enhance its liquidity profile vis-à-vis other credits. Also, the asset management environment in which mortgages are originated and managed strongly determines the ability to exchange the assets for cash in a timely and cost-efficient manner. Lastly, we will explore certain alternative routes that allow investors to extract cash from residential mortgages, particularly in a market environment where these investors may be facing the need for temporary liquidity solutions.

> ***In 2023 alone, DMFCO has facilitated 4 mortgage portfolio transactions on its platform with an aggregate value in excess of € 350 million. Through its capital markets function, DMFCO has also provided mortgage-backed liquidity solutions to investors***

At DMFCO, we have observed a growing demand from our investors to discuss liquidity solutions and we have been able to provide such solutions in various forms. In this article, we aim to provide an overview of available options, allowing a (re)assessment of Dutch residential mortgages from a liquidity perspective.

High credit quality, homogeneity, and granularity underpin liquidity

Due to a highly regulated credit environment, Dutch residential mortgages have a very strong credit profile. With expected losses rarely exceeding a few basis points, the asset class has a (very) high investment grade implied credit rating. If a lender subsequently applies a consistent, transparent and balanced underwriting framework, the originated mortgages exhibit a high degree of homogeneity. This homogeneity or uniformity ensures that these mortgages, provided they have similar characteristics, can easily be interchanged. On a portfolio level, granularity of the mortgages ensures that idiosyncratic behaviour of individual loans is mitigated, which in turn facilitates the economic assessment of the portfolio's value between a potential buyer and a potential seller.

As a result, Dutch residential mortgages are largely commoditised. The need for due diligence is typically limited, especially when prospective buyers are already familiar with the asset class and the originating/servicing platform. In practice, most discussions will then tend to circle around legal fine-tuning and economics.

Size matters…

As mentioned, the size of a portfolio facilitates analysis and insulates against individual mortgage events. Scale however, is also relevant for a different reason. As with other tradeable assets, it is important to have a sufficiently large market place, where supply-demand is met in order to facilitate a timely and cost-effective execution of a potential portfolio transaction.

At DMFCO, we manage €28 billion of Dutch residential mortgages, from 36 institutional investors. These investors range from pension funds and insurance companies to sovereign wealth funds and banks - and all of them have different asset and liability profiles. Some investors have built up seasoned portfolios whereas other investors are in the ramp-up phase of their investment. As a consequence, we see that these investors have divergent interests and investment drivers which may lead to a need to expand, adjust or rebalance their mortgage investments.

DMFCO has developed a process and provides support to efficiently facilitate portfolio transactions. The process, legal documentation and settlement procedures are standardised and facilitated by DMFCO, resulting in limited effort by and very low transaction costs for the buyers and sellers. Whilst DMFCO remains a neutral party between buyer and seller, it can also provide valuation support in line with the methodology for month-end valuations that DMFCO already provides to its investors.

All investors perform regular due diligence on the DMFCO platform, reviewing aspects such as mortgage origination, servicing, credit policy and underwriting framework. As a result, the due diligence requirements in case of a portfolio acquisition can generally be limited to portfolio specific issues, economics and (transaction related) legal considerations.

> ***"In 2022 we took the decision to increase our allocation to mortgages via DMFCO. With this increase we aim to rebalance our mortgage portfolio in line with our strategic asset allocation. Thanks to the portfolio transaction, we have been able to reach this target more quickly and more efficiently"***

Joseph Benjaminsen

Senior Portfolio Manager External Mandates, Pension fund Rail & OV

Alternative liquidity solutions

Given the homogeneity and high credit quality of mortgage portfolios, they are also well suited for use as collateral to access temporary liquidity or funding. This funding option, which achieves liquidity without economically disposing the portfolio, can be used for back-up liquidity planning. This further strengthens the case for the increased liquidity of mortgage investments.

There are various ways in which mortgage portfolios can be used to access this type of liquidity, below we explore two specific examples:

1. Mortgage backed financing: A mortgage portfolio is transferred to a bankruptcy remote SPV, which in turn attracts financing from a commercial bank. The financing is passed on to the mortgage investor and can be used for general purposes. The interest and amortisation of the mortgages are used to service the warehouse financing.
2. Securities lending: The mortgages can be converted into residential mortgage backed securities ('RMBS') or other forms of asset-backed notes. These are in turn used as collateral to attract repo financing. The notes can be structured as relatively simple pass-through notes or with more complex features to optimise liquidity, depending on the specific needs of the investor. To facilitate guaranteed and direct access to liquidity, the repo terms can be pre-agreed with banks (committed financing). Repo interest rates range between AAA-rated RMBS levels on the lower end and unsecured lending rates at the upper end.

Conclusion

Recent market developments have underscored the importance of liquidity in investment portfolios. Whilst Dutch residential mortgages are generally perceived as illiquid, they possess characteristics which enhance their liquidity profile relative to other credit assets. Most notably mortgages' homogeneity, strong credit profile and granularity provide for an easy to understand and tradeable asset class. This is even further enhanced when mortgages are originated under a single label, are supported by a robust operational process and benefit from a uniform set of legal documentation. Due to the scale of DMFCO's platform, it serves as a marketplace where supply and demand can meet and where mortgage portfolios can be traded efficiently. Finally, the mortgages can be used as powerful collateral for back-up liquidity planning.

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