Special Report 2011/02

Credit crisis puts mortgage funding in eurozone countries to the test

The credit crisis has affected different European mortgage markets in differing ways. This Special Report argues that those differences can be largely traced to the degree of countries' dependence on securitisations as a source of funding before the crisis. The securitisation market has been hit hard, certainly compared to the market for covered bonds, for instance. Mortgage markets that depend(ed) heavily on securitisations as a source of funding, such as that of the Netherlands, experienced higher mortgage rates in 2009-2010 partly for that reason. This result puts not just mortgage margin calculations at a national level under the spotlight. It also highlights the unequal impact of proposed tighter supervisory rules for securitisations, under which securitisations will not and covered bonds by contrast will continue to form part of liquid banking buffers.

Background

The credit crisis has fundamentally changed the pricing of financial products. The general repricing of risk has made the price structure of financial products more obscure and less transparent for many consumers. This aspect of the impact of the crisis is clearly illustrated by the mortgage market. The rising funding costs and their pricing into mortgage rates has already given rise to sharp criticism in the Netherlands, for example from the home-owners association 'Vereniging Eigen Huis' and the consumer association 'Consumentenbond', as well as an investigation by the Netherlands Competition Authority NMa into mortgage interest margin calculations.

An international perspective

Figures 1a-1d compare European mortgage rates on the basis of four different fixed-rate periods. Each chart shows the average European interest rate (solid blue line) and the interest rate of the countries with the lowest (striped blue line) and highest (dotted blue line) mortgage rate respectively. The Dutch interest rate is represented by the orange line.

At a European level we see the mortgage rate rising compared to the relevant swap rate (solid purple line) in 2008-09.[1] This reflects the general repricing, referred to above, of risk in financial markets, owing to which the funding costs for all European mortgage markets are higher at present than before the crisis. A price has been put on liquidity again.

In addition, it is striking that from the end of 2008, or the beginning of 2009 (depending on the term being considered) the Dutch mortgage interest rate – which before the crisis moved reasonably in line with the European average – became one of the highest in the eurozone in a comparatively short time. The impact of the crisis on the Dutch mortgage market therefore appears to have differed from that in many other eurozone countries. A Dutch mortgage rate that is relatively high in an international perspective is unmistakably a new phenomenon, and it is necessary to examine the factors underlying it. This Special Report focuses on developments of an aspect of national mortgage markets that has remained underexposed until now, which is their funding dependence on securitisations (RMBS) and covered bonds (CB).

The widespread use of securitisation

The funding of Dutch mortgages depends strongly, in an international perspective, on the securitisation market.[2] Up until the crisis,

[1] The Spanish mortgage rate for 5-10yr fixed-rate periods developed very differently even long before the crisis and is therefore not included in the remainder of the analysis.
[2] Also known as the market for Residential Mortgage Backed Securities, or RMBS in short.

Figure 1a: Mortgage rate, fixed up to 1yr

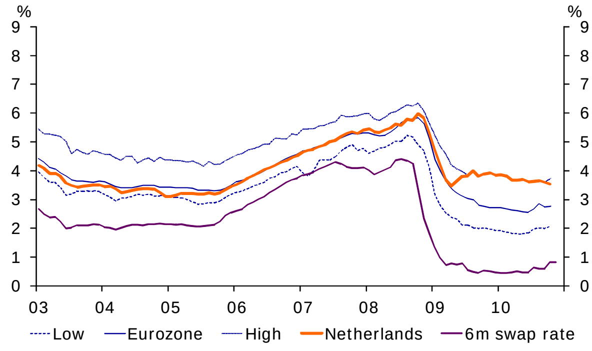


Figure 1b: Mortgage rate, fixed 1-5yrs

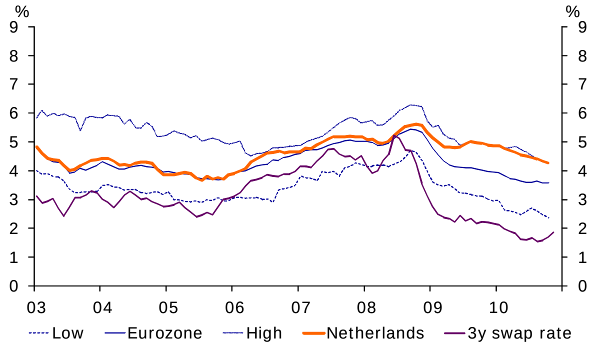


Figure 1c: Mortgage rate, fixed 5-10yrs

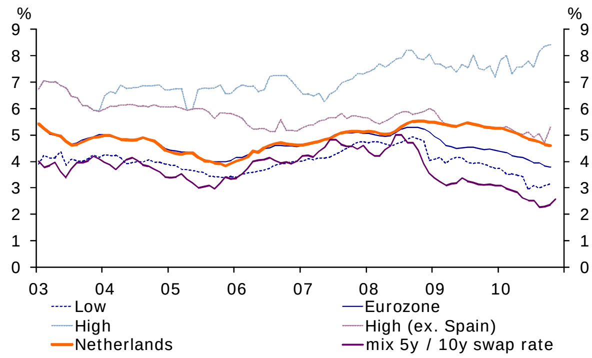
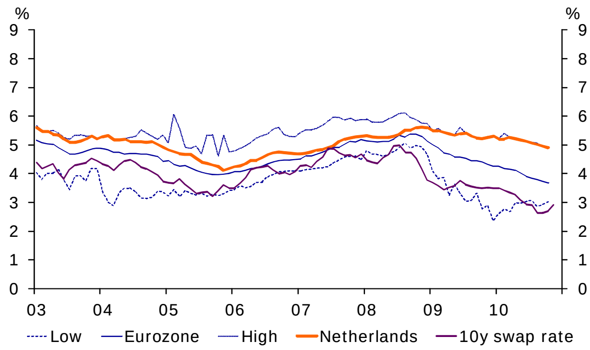


Figure 1d: Mortgage rate, fixed 10+yrs



Source: European Central Bank (ECB)

securitisation offered some respite in the tight Dutch savings market in which substantial savings were invested via pension and insurance funds in financial instruments – including securitisations – instead of being available on banks' balance sheets in the form of savings balances for direct bank funding. In 2007 over one quarter of all Dutch mortgages outstanding were financed by means of securitisations, markedly more than elsewhere within the eurozone (figure 2a).
The figure also shows clearly how the size of securitisation volumes compared to the mortgages outstanding rose significantly in many countries during the crisis. But this is not really about funding mortgage portfolios any more. Instead, banks carried out extensive securitisations of mortgages with the aim of having these available (preventively) to be offered as security to the ECB in exchange for (emergency) liquidity.

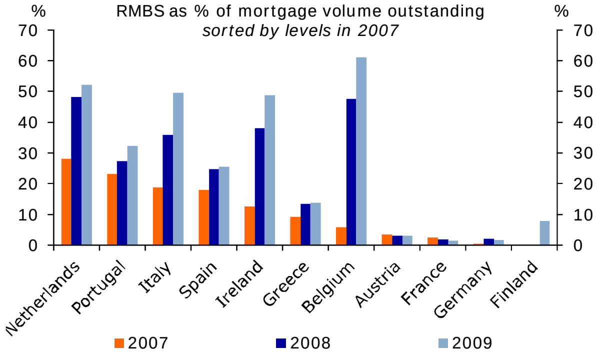
The limited use of covered bonds

Covered bonds are similar to RMBS, except that CBs are issued by a bank with extra security (cover) in the form of a specific portfolio of mortgages, while an RMBS, strictly speaking, only has the mortgage portfolio as security. CBs therefore provide double cover, while RMBS can also be issued by non-banks.

Covered bonds are of comparatively little importance for the Dutch mortgage market (figure 2b). This is partly due to the openness of the Dutch mortgage market and the large number of non-bank lenders, which can issue RMBS but not CBs. In addition, the credit rating for CBs relates to the issuer, while for RMBS it relates primarily to the underlying mortgage portfolio.

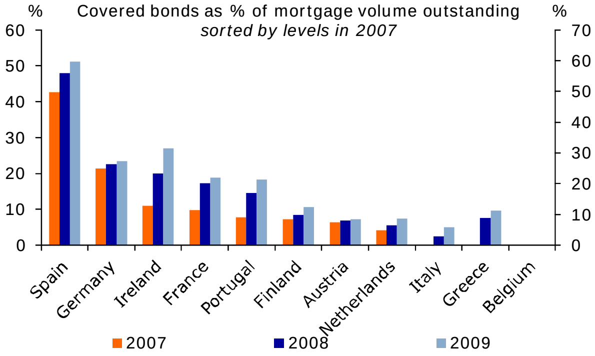
During the crisis the covered bond market was also supported by policy intervention, mainly in the form of the ECB's covered bond programme, in which it bought up € 60 billion in covered bonds that it intends to keep until maturity. This helped the covered bond market to weather the crisis better than did the securitisation market.

Figure 2a: The Dutch rely on securitisation…



Source: European Securitisation Forum (ESF), ECB

Figure 2b: … and hardly on covered bonds



Source: European Covered Bond Council (ECBC), ECB

Securitisations vs covered bonds

The credit crisis hit securitisation markets much harder than the covered bond markets, in terms of the spreads payable to investors for holding the securitisations as well as the willingness of the markets to accept issues of new securitisation issues at all.[3]

Before the crisis, investors demanded only a few basis points yield (on top of EURIBOR) for securitisations (5yr) of premium-grade Dutch mortgage packages. At the end of 2008 secondary markets peaked at 400bp (for comparable British securitisations in fact as much as 500bp) and at the end of 2010 these premiums were still above 120bp. Covered bond markets as a rule experienced a much more moderate rise of premiums, and prices for German covered bonds have in fact even almost fully recovered by now.

In addition, the securitisation market was effectively closed for issues during the whole of 2008 and also 2009. Securitisation programmes were still being carried out, but as stated above this was only to create pledgeable assets for the ECB. It took until the first half of 2010 for the securitisation market to open up cautiously again and contribute to the funding of mortgage markets. By contrast this had already been the case since the start of 2009 for covered bonds.

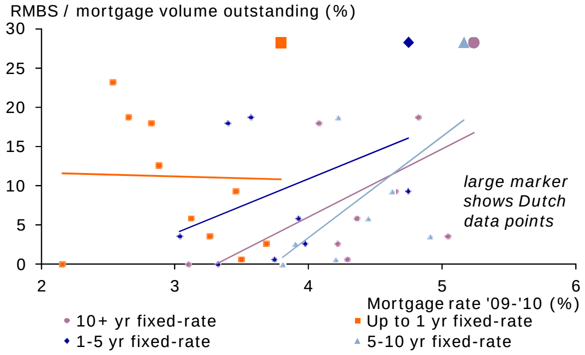
[3] Frank Will & Sophia Kwon (2010), "RMBS vs. Covered Bonds," 2010 ECBC European Covered Bond Fact Book, pp. 80-87.

The *low* Dutch mortgage rates

The mortgage rate effect of RMBS or CB dependence respectively in national mortgage markets can be analysed by plotting pre-crisis dependence against post-crisis mortgage rates. Figure 3a shows, for the eurozone countries, the correlation between the RMBS dependence in 2007 and the average mortgage rate in 2009-2010. Fixed-rate periods are marked by different colours, with larger markers representing the Dutch situation. For each fixed-rate period, a trend line shows the linear connection between the RMBS dependence before and the average mortgage rate since the crisis. Similarly, figure 3b shows the relation between the covered bonds issued and the mortgage rate in 2009-2010.

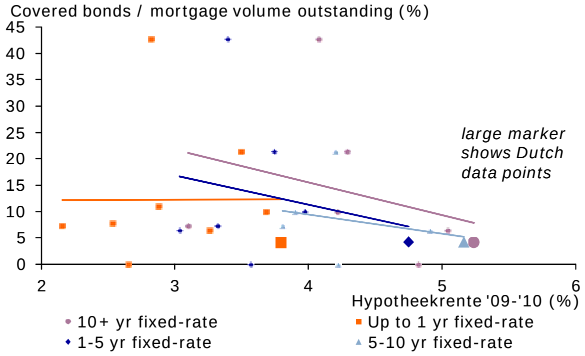
It is striking to see how – except for mortgages with fixed-rate periods of up to one year – there is a clear *positive* correlation between the dependence on RMBS funding and the level of the mortgage rates in the years in which that market was 'closed' as a result of the crisis. This can be seen in the rising trend lines that have been added in the chart for the fixed-rate periods: the greater the dependence on RMBS as a source of funding before the crisis, the higher the mortgage rates since the crisis broke out. And it may be even more striking to see there is a clear *negative* correlation between the dependence on covered bond funding and mortgage rates in the years of crisis which the covered bond markets weathered comparatively well. The impact of the crisis was by no means the same

Figure 3a: 'RMBS markets' after crisis...



Source: ECB, ECBC, ESF, Rabobank

Figure 3b: ... differ from 'CB markets'



Source: ECB, ECBC, ESF, Rabobank

across the mortgage markets of the eurozone. The greater the dependence on securitisations, the more severe it was. In that perspective the Dutch mortgage rates in fact do not appear to be higher at an international level at all. The trend lines in figure 3a would indicate rates of 5½%–6½% for Dutch mortgages with fixed rate periods from 1yr upwards, whereas effectively they ranged between 4¾%–5¼%. A thought-provoking result, which obviously requires some qualification.

Other current and future effects

The funding dependence of a mortgage market obviously explains only part of the elements in mortgage rates in the first instance. The development and institutional design of national savings markets, competitive playing fields, state interventions during the crisis and the ease with which foreign parties can enter and exit all play apart as well and are not included in the analysis above. But despite the simplicity and limitations of the analysis it remains striking to observe how even on the funding side alone the institutional frameworks of national mortgage markets lead to highly diverse consequences of the crisis.

The results found also provide an understanding of the effects of the Basel proposals for tighter regulation of securitisations. The proposals aim to exclude investments by banks in RMBS from liquid buffers. The implication is that securitisations will become less attractive for banks to buy and retain. Issuing securitisations in sufficient volumes and at acceptable prices is therefore likely to remain a challenge in the future. Mortgage funding in RMBS-dependent markets, such as the Netherlands, is therefore probably set to remain difficult, and in turn will entail effects that tend to raise mortgage rates.

Conclusion

As a rule, mortgage markets that relied heavily on securitisations for funding before the crisis experienced higher mortgage rates in the years 2009-2010. The Dutch mortgage market is one of these; over one quarter of all Dutch mortgages were financed by means of securitisation in 2007. The institutional frameworks of mortgage markets can clearly contribute to highly divergent effects of crises. The Dutch mortgage rate – which has risen in an international perspective since the crisis broke out – does not appear excessively high after all in the light of the Dutch dependence on the still–troubled securitisation market.

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