Investment in Dutch Residential Mortgages: Eligibility under the Matching Adjustment Framework

Part 1

Achmea Mortgages

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- Expansion of Matching Adjustment to include highly predictable cashflows.
- Dutch residential mortgages meet eligibility under reformed MA framework.
- Benefits for insurers: ALM, capital optimization, risk-adjusted returns.

REGULATORY BACKGROUND: MATCHING ADJUSTMENT AND RECENT REFORMS

Under Solvency II, the MA was designed to allow insurers to adjust the discount rate on their liabilities, which is crucial for maintaining financial stability and managing capital requirements. To qualify, the assets must generate fixed cashflows that are closely aligned with insurers' liabilities.

On April 15, 2024, the PRA published a review proposing an expansion of the MA to include assets with HP cashflows. These assets, while not having fully fixed cashflows, offer a high degree of predictability within specific contractual boundaries. The expansion is expected to provide greater flexibility in investment choices for insurers, subject to safeguards such as a 10% cap on the MA benefit derived from HP assets. The PRA has publised further guidance on this expansion.

Criteria for MA Eligibility

To qualify for the Matching Adjustment (MA) under Solvency II, investments must meet strict criteria that align with the regulatory framework's objectives of ensuring financial stability and capital adequacy for insurers. These requirements are designed to ensure that the assets backing long-term insurance liabilities, such as annuities or pension obligations, exhibit predictable and stable cashflows. While the recent reforms introduce greater flexibility, particularly with the inclusion of assets with highly predictable (HP) cashflows, meeting the fundamental eligibility criteria remains crucial for insurers to benefit from the MA.

Long-Term and Stable Cashflows

Eligible assets must provide stable, predictable cashflows over time, allowing insurers to match their liabilities, such as annuities or pension obligations. Investments should have a clear, contractual repayment structure to ensure this predictability.

Low Credit Risk
Eligible assets must demonstrate a low probability of default, with strong credit profiles supported by historical performance data and collateralization. This ensures that insurers are not exposed to undue risk from investments that are intended to provide stability.

Compliance with Solvency II Requirements
Investments must comply with all regulatory requirements under Solvency II, ensuring that they align with the legal and financial frameworks governing insurers. This includes documentation and reporting obligations that verify the MA compliance of the assets.

Expansion to Highly Predictable Cashflows
The PRA's proposal allows for the inclusion of assets with HP cashflows, which, while not entirely fixed, offer predictability within defined parameters. The timing and amounts of these cashflows can vary slightly due to economic factors or contractual terms, but they remain highly predictable. Safeguards such as a 10% cap on the total MA benefit from HP assets ensure that insurers maintain a balanced investment portfolio without excessive reliance on more variable assets.

Dutch Residential Mortgages and Matching Adjustment
Dutch residential mortgages possess characteristics that align with the criteria for assets with HP cashflows under the MA regime. Several features of Dutch mortgages make them particularly suitable for inclusion:

Long-Term Nature
Dutch residential mortgages typically have long durations, often exceeding 20 years. This long-term nature matches the extended duration of insurers' liabilities, such as pension obligations and annuities, making these mortgages a suitable investment for insurers seeking to manage long-term cashflows.

Fixed Interest Rates
Many Dutch residential mortgages feature long-term fixed interest rates, providing stability in cashflows over the mortgage term. The fixed interest structure allows insurers to accurately predict the future income from these assets, a key factor in maintaining a stable liability management strategy.

Low Credit Risk
The Dutch mortgage market is characterized by stringent underwriting standards and a strong legal framework that supports mortgage lending. Dutch borrowers are known for their high payment morale, contributing to low default rates and arrears. These factors significantly reduce the credit risk associated with Dutch residential mortgages, making them attractive to insurers under the MA framework.

Prepayment Risk Management
Prepayment risk, where borrowers repay mortgages early, is a potential challenge for insurers. However, this risk can be mitigated through contractual mechanisms, such as prepayment penalties or portfolio diversification, ensuring that insurers can still rely on the overall predictability of cashflows from Dutch residential mortgages.

Safeguards for HP Cashflows
As the Matching Adjustment (MA) framework expands to include assets with highly predictable (HP) cashflows, it is essential to implement safeguards to ensure the stability and reliability of these investments. The Prudential Regulation Authority (PRA) has proposed specific measures to manage the inherent risks associated with HP cashflows, which, while not entirely fixed, offer a high degree of predictability. These are:

- **10% Cap on MA Benefit:** This cap limits the proportion of an insurer's MA benefit that can be derived from assets with HP cashflows, ensuring that the overall investment strategy remains balanced and focused on stability.

- **Contractual Boundaries:** Assets with HP cashflows must have clear contractual terms that define the timing and amounts of cashflows, ensuring that the degree of predictability is comparable to fixed cashflow assets.

- **Credit Ratings and Risk Management:** Insurers will need to demonstrate that assets with HP cashflows meet certain credit rating standards and are supported by robust risk management frameworks.

Benefits for Insurers Investing in Dutch Residential Mortgages

The inclusion of Dutch residential mortgages in MA portfolios offers several advantages to insurers such as long-term characteristics, stable cashflows. These mortgages align well with insurers' liabilities, such as annuities and pensions. The strong credit profile and fixed-rate nature of many Dutch mortgages enhance their appeal for capital efficiency and risk management.

Expanded Asset Choice

The expansion of the MA regime to include HP cashflows provides insurers with a broader range of asset classes, allowing for greater diversification beyond traditional fixed cashflow instruments.

Enhanced Risk Management

Insurers will need to strengthen their risk management practices to accommodate assets with HP cashflows. Dutch residential mortgages, with their stable and predictable nature, can play a key role in this strategy.

Capital Efficiency

By investing in Dutch residential mortgages, insurers can benefit from reduced capital requirements under Solvency II, improving overall capital efficiency and freeing up resources for other strategic investments.

Improved Asset-Liability Matching (ALM)

The stable and predictable cashflows from Dutch residential mortgages help insurers align their asset portfolios more closely with their liabilities, improving ALM practices and reducing interest rate risks.

Diversification and Risk-Adjusted Returns

Dutch residential mortgages offer diversification benefits when combined with other asset classes, such as bonds and equities. Their long-term stability and low volatility can enhance risk-adjusted returns for insurers in combination with relatively low capital charges.

Make whole clause

The "make whole" clause, though not strictly necessary, can play a valuable role when combined with tranching to absorb volatility. However, as tranching generally also requires a higher return in comparison with whole loan investors. The business case for such tranching is becoming increasingly relevant as market conditions have evolved. This is primarily due to the declining value of swaps and the subsequent widening of credit spreads, which have heightened the importance of managing variability of cash flows. By incorporating tranching, investors and insurers can more effectively navigate market fluctuations, maintaining stability in their portfolios despite the changing economic landscape (e.g. when stress-testing prepayment and default scenarios).

Conclusion

Dutch residential mortgages present a compelling investment option for insurers under the expanded Matching Adjustment regime. Their long-term, stable, and predictable cashflows, combined with a low credit risk profile, make them well-suited to help insurers manage their liabilities and improve their capital position.
By diversifying their portfolios with assets such as Dutch residential mortgages, insurers can achieve better asset-liability matching, optimize capital efficiency, and enhance their risk-adjusted returns, ultimately contributing to a more robust and stable financial position under Solvency II.
As a leading provider in the Dutch mortgage market, Achmea Mortgages offers deep expertise in managing high-quality, long-term mortgage assets. With our proven track record in delivering stable and predictable returns, Achmea Mortgages is well-positioned to support insurers in navigating the evolving regulatory landscape and capitalizing on the opportunities presented by the reformed Matching Adjustment framework.

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