Dutch Residential Mortgages: Despite Recent Measures Vulnerabilities Persist

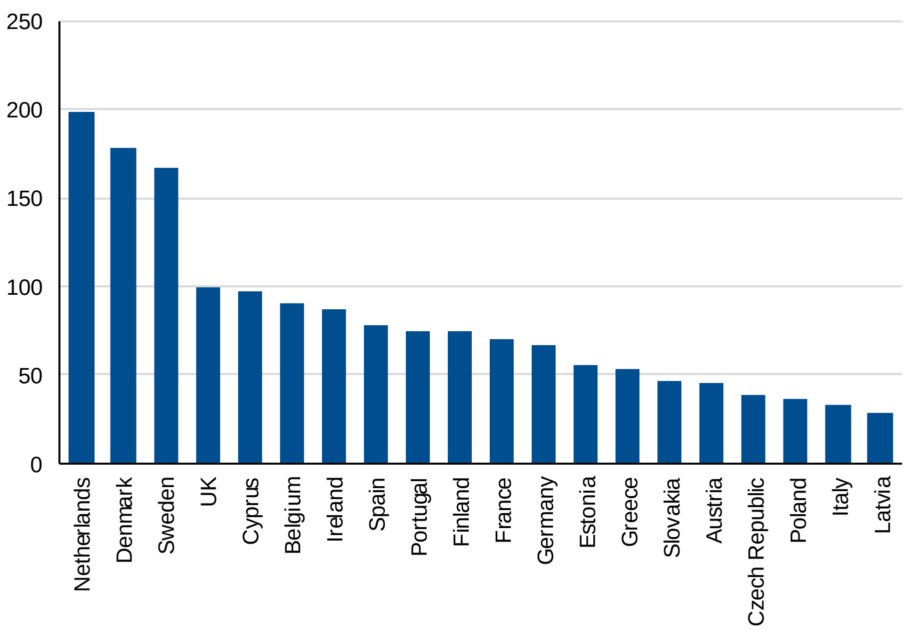
The Dutch residential mortgage market is characterised by a preference among households for non-amortising loans (explained by tax relief measures long in existence in the country), which in turn explains lenders' above-average current loan-to-values. In this report, Scope aims to bring an analytical focus on the Dutch residential mortgage market, highlighting both risks and areas of strength. Currently, the agency has public ratings on two Dutch banking institutions: ING Bank (AA-, Stable) and Rabobank (AA-, Stable).

Recent measures are tackling vulnerabilities in the sector. Steps aimed at improving borrower incentives have proven relatively successful, compared with those prompting lenders to tighten origination standards.

Despite recent steps, primarily towards improving borrowers' incentives in the market, Scope believes that further measures in the Dutch mortgage market could help decouple lenders' exposure risk to adverse market circumstances. It also deems the statutory LTV limit to be high against international standards and Dutch-specific standpoint. A lower limit, with a shorter implementation timescale than the one proposed by the Financial Stability Committee, could be a positive development.

As Figure 1 shows, Dutch households are highly leveraged. The share of residential debt to disposable income, despite the decline in recent years, is still the highest among EU countries. European Mortgage Federation data also show a high level of indebtedness, with per-capita residential loans at EUR 49,000, significantly higher than the EU28 average of EUR 17,000.

Figure 1: Outstanding residential loans to disposable income across the EU (%)



Source: European Mortgage Federation National Experts, European Central Bank, National Central Banks, National Statistics Offices, Eurostat, Federal Reserve, US Bureau of Census

Historically, the tax deductibility of mortgage interest incentivised Dutch households to choose interest-only mortgages (or hybrid forms) and to finance higher shares of the property price.

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Besides annuity and linear mortgages, Dutch homebuyers can select non-amortising loans and other hybrid forms which combine an interest-only loan with a savings account, an insurance or an investment account. These accounts can be kept with counterparties other than the lender, and in that they may be different from a Bauspar account in Germany or Austria, or a Plan d'epargne lodgement (PEL) in France.

Figure 2: Dutch mortgage schemes

Annuity/Linear mortgage (Annuïteitenhypotheek/ Lineaire hypotheek)	The principal is repaid during the lifetime of the mortgage through instalments
Interest-only mortgage (Aflossingsvrije hypotheek)	No monthly instalments, only interest is paid for the duration of the mortgage, the principal is repaid at maturity
Savings mortgage (Spaarhypotheek)	Monthly transfers are made into a savings account, with a fixed return equal to the interest to be paid on the mortgage. At maturity, the mortgage is repaid out of the account
Endowment mortgage (Levenhypotheek)	Similar to a savings mortgage, but with a return linked to market rates
Investment mortgage (Beleggingshypotheek)	Periodical payments are made into an investment fund or invested in the stock market

Source: DNB Occasional Studies Vol. 13-4

Recent measures …

In the past few years several initiatives have been undertaken to address vulnerabilities in the sector, such as (I) high household indebtedness, (II) a high share of mortgages with negative equity (ca. 20% in 2016), and (III) a high share of non-amortising loans. We cite the following:

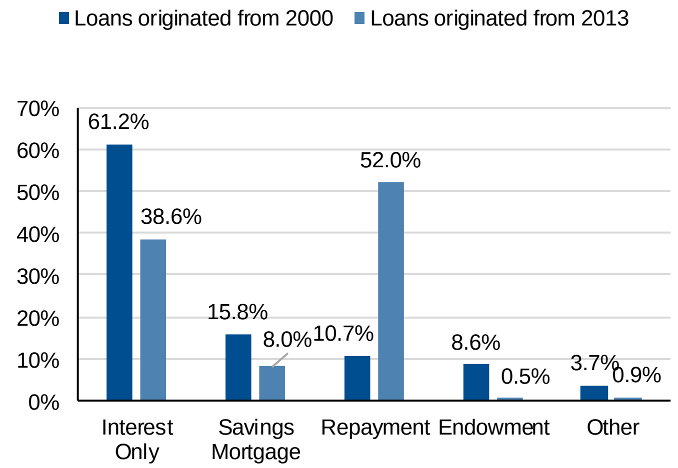
- Since 2013, tax deductibility of interest payment applies only to new mortgage loans that fully amortise within 30 years, with existing loans being 'grandfathered'.
- Share of market value financed with interest-only mortgages limited to 50%. This limit was agreed in 2011 via a code of conduct within the mortgage industry, in cooperation with the government.
- Limit to the debt-service-to-income (DSTI) ratio. Every year the Ministry of Finance determines a maximum share of annual disposable income for servicing mortgage payments (interest plus repayments). Officially enacted in 2013, this limit previously formed part of the code of conduct mentioned above.
- Limit to mortgage interest deductibility. in 2014, the maximum tax rate for the deductibility of mortgage interest was set at 51.5% and is reduced by 0.5% per year until it reaches 38%. This applies for both existing and new mortgages.
- Gradual implementation of LTV caps. Starting in 2013, a decree imposed a maximum LTV of 105%, to be reduced by 1% per year until it reaches 100% in 2018. In a 2015 document[1] the Financial Stability Committee recommends a gradual reduction to 90% after 2018, at a pace of 1% p.a.

[1] Recommendation from the Financial Stability Committee on the LTV limit after 2018

... led to changes in mortgage debt composition …

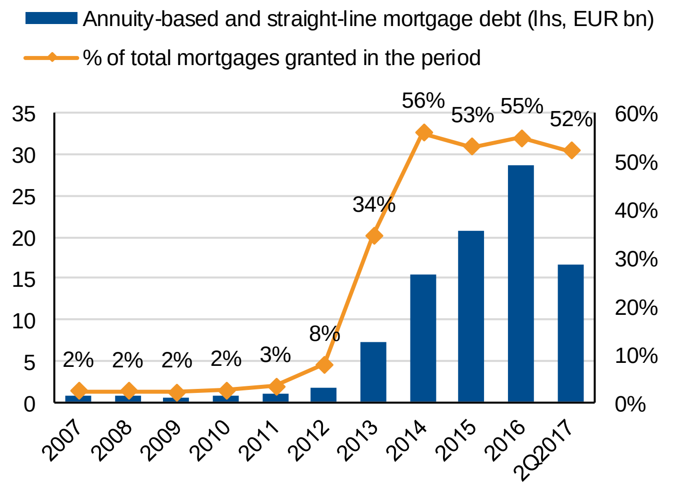
According to data from the European DataWarehouse, the share of repayment mortgages within the sample of RMBS with Dutch assets have increased. Of the current sample of EUR 223bn of mortgage loans originated between 2000 and 2017, 61.2% were interest-only. The share drops to 38.6% for the loans originated in or after 2013.

Figure 3: Loans (or parts of) underlying Dutch RMBS by repayment method



Source: European DataWarehouse

Figure 4: Mortgage debt outstanding as at Q2 2017 by year of grant

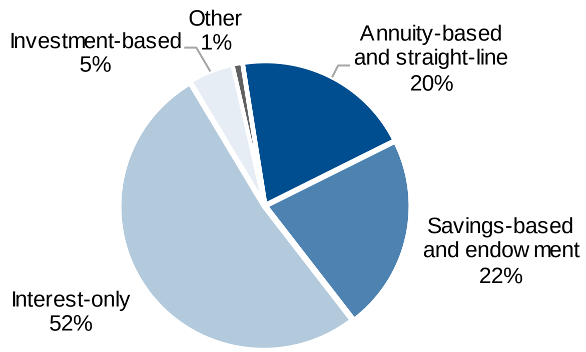


Source: DNB loan level data

The Dutch Central Bank's (DNB) autumn 2017 financial stability report paints a similar picture: the share of either annuity-based or linear mortgages on mortgage debt outstanding as of H1 2017 has increased considerably. The quasi totality (94%) of outstanding repayment mortgages was originated post 2013. This increase mirrored a decrease of all other types of mortgages, but correlates more strongly with the declining share of savings and endowment mortgages.

Despite the afore-mentioned recent measures, more than half of outstanding mortgage debt in the Netherlands is still interest-only as of Q2 2017, partly due to the sheer size of the stock. Moreover, of the mortgage loans granted in Q2 2017, 39% is interest-only.

Figure 5: Mortgage debt outstanding as of Q2 2017



Source: DNB loan level data

… but were less effective on LTVs

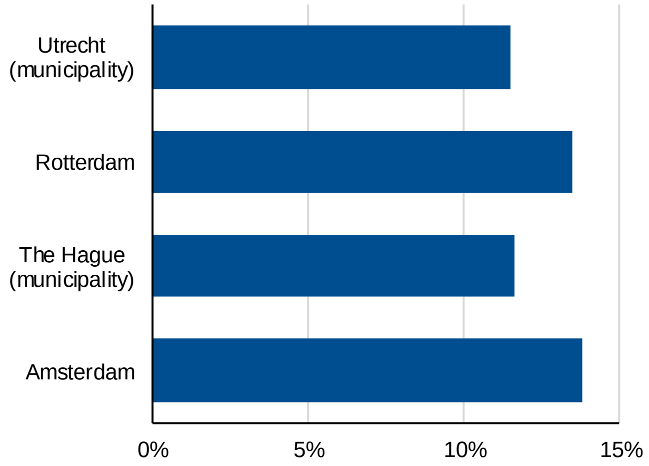
The high leverage among Dutch households is reflected in the LTVs at origination: 97.5% for first-time buyers in Q4 2016[2], which is at the upper end of European countries. Not only is the current limit on LTVs at origination high compared with other European countries' standards, the 90% cap to be phased in over the next 10 years also appears too generous compared to international standards.

An indicator to be looked at with some caution

That said, we note that current LTVs are calculated as residual loans divided by indexed house values. In the case of savings and endowment mortgages, there is no visibility on payments made into accounts earmarked for repayment at maturity. Therefore, this metric underestimates capital accumulation at disposal for servicing debt. Conversely, for investment mortgages such a balance might differ from the principal, hence not guaranteeing full repayment at maturity. As of Q2 2017 savings and endowment mortgages represented 22% of the total outstanding, and investment mortgages 5%.

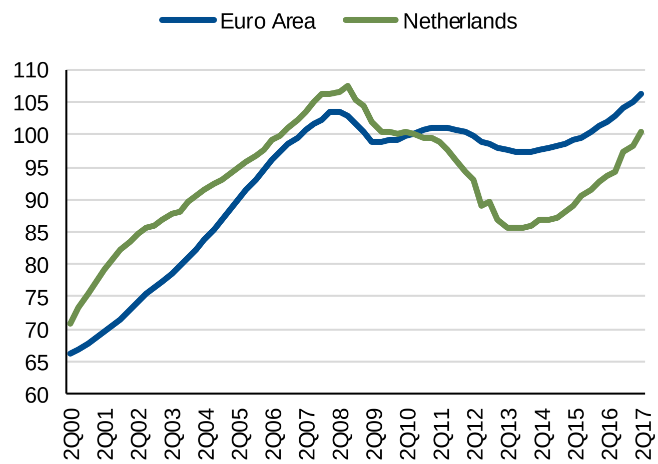
Moreover, current LTVs, while benefiting from the transition to repayment mortgages, have also improved thanks to an upswing in the residential property market in the past four years. Prices in some regions, especially urban centres, have risen significantly. Conversely, and given the pro-cyclicality of this measure, sudden drops in market values would push up current LTVs.

Figure 6: Prices Q3 2017 YoY% change, existing own homes



Source: Statistics Netherlands

Figure 7: Nominal house prices, 2010=100



Source: OECD

National Guarantee as risk mitigation tool

Another level of protection for lenders is provided by the National Mortgage Guarantee (Nationale Hypotheek Garantie, or NHG). Introduced in 1995, the scheme is operated by a non-profit government-backed foundation, Homeowners' Guarantee Fund or Waarborgfonds Eigen Woninge (WEW), and covers interest and/or principal payments in case of unforeseen circumstances affecting the borrower (like unemployment, divorce, disability or death). For the lender, this means the loan is repaid fully upon a forced property sale. The NHG has a mitigating effect on the lender's credit risk and is, as such, recognised as a credit risk mitigant under Basel III for both the standardized and the Internal models approach.

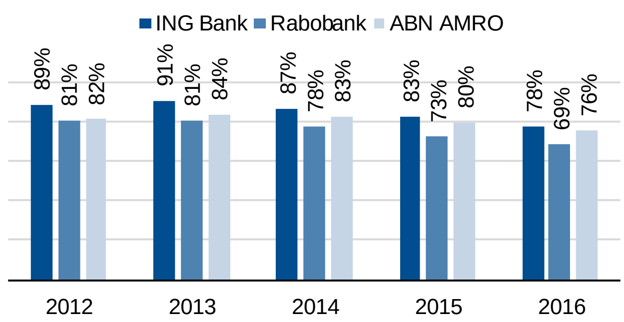
[2] DNB, Autumn 2017 financial stability report

Data from the Netherlands' cadaster show that between January and November 2016 approximately 74% of the mortgages issued below the EUR 245,000 2016 ceiling, under which the guarantee applies, were NHG-backed.

Evidence from the banking sector

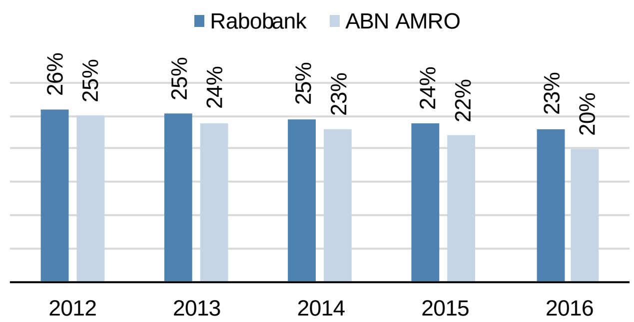
Improving trends are evident when looking at the three large banking groups in the country: ABN AMRO, ING Bank, and Rabobank. They have all displayed improving average LTVs as well as a decreasing share of interest-only Dutch residential mortgages (Figure 8). The three banks together make up roughly 80% of Dutch banking assets, and 87% of residential mortgage lending by banks.

Figure 8: Average loan-to-values on the Dutch residential mortgage portfolio



Source: Company data

Figure 9: Share of fully interest-only mortgages



Source: Company data

Between 2012 and 2013 the decline in house prices led, at least partially, to an increase in LTVs. The ratio improved from 2014, reflecting the recovery in residential property values as well as the increasingly higher share of newly originated repayment mortgages. Moreover, risks are partially mitigated by the NHG, which as of YE 2016 was covering 20% to 26.3% of the portfolio.

Figure 10: Metrics comparisons as of YE 2016

	ING Bank	Rabobank	ABN AMRO
Dutch residential mortgage portfolio (EUR m)	123,873	195,909	149,255
Average portfolio LTV	78.0%	69.0%	76.0%
% Covered by NHG	20.1%	20.6%	26.3%
% Loans fully interest-only	na	23.1%	20.0%

Source: Company data

Conclusions

Scope's view is that there is visible evidence of a recent shift towards a more balanced composition of mortgage debt, with annuity and linear mortgages acquiring relevance at the expense of other mortgage types, especially interest-only and savings/endowment mortgages.

We noted a shift of preferences, away from savings and endowment to schemes entailing regular repayment of principal: since the DSTI ratio limit was enforced in 2013, lenders have been considering payments made by borrowers into side accounts and in general relying on an adequate measure of current disposable income in their lending decisions. As tax incentives were modified in 2013, households moved from savings and endowment to annuity and linear mortgages.

We believe the decrease in the popularity of non-amortising loans is a result of, in primis, the re-alignment of tax incentives, but also the self-imposed limits to the interest-only financing in the 2011 code of conduct. We however note that, given the length of mortgage terms and the characteristics of the stock of debt, coupled with the fact that these initiatives are relatively recent, a more meaningful effect on average LTV would take time.

As a more decisive remedy for the vulnerabilities of mortgages to adverse scenarios and to increase resilience in the financial system, more stringent LTV limits to be phased in a shorter time horizon than the one currently under discussion might be warranted.

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