Special report 2012/02

Dutch mortgage market: a liability?

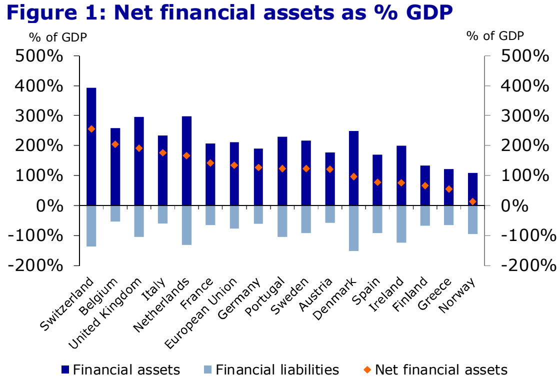
Dutch gross mortgage debt totals 106% of GDP, which is higher than any other EU country. Also, the Loan-to-Value (LTV) of Dutch mortgages is high from both a historical and an international perspective. While there are certain risks associated with high levels of mortgage financing, the risks are not as high as some suggest.[1] In this Special Report, we describe the unique characteristics of the Dutch mortgage market, and give our views on the related risks.

Household assets and liabilities

Home owners in the Netherlands have a relatively high mortgage debt (EUR 640 bn[2]), or 106% of GDP. Relative to GDP and gross disposable income, this is higher than any other EU country. The high gross debt level is mainly due to the tax policy applied to the housing market. Mortgage interest for the primary residence can be fully deducted from taxable income during 30 years. This reduces the net interest payments and makes it attractive for households to maintain a high gross mortgage debt coupled with a long term savings account and to redeem the loan at the final maturity date. In contrast to mortgage debt and to other countries, consumer credit is negligible in the Netherlands (EUR 28 bn).

Against these liabilities there are large assets. First, there is a considerable amount of private savings (EUR 358 bn). Second, households possess stocks and other financial assets with a value of EUR 86 bn. Even more important are retirement savings. Next to a unique treatment of mortgage rate interest payments, the Dutch have a unique three-pillar pension system.
The first pillar is a pay-as-you-go system similar to other countries. The second pillar consists of a mandatory collective private pension plan for employed workers. Savings in the second pillar amount to 809 billion euro's. This capital is managed by single or multi-employer pension funds.
Finally, the third pillar consists of voluntary individual pension savings. Some EUR 181 billion is accumulated in individual life insurance products for retirement purposes.

Figure 1: Net financial assets as % GDP



Source: Eurostat (2010)

Net financial assets of households

When we net the liability and the asset sides of the balance sheets of households, we find a positive net financial position of EUR 768 bn, excluding the value of the owner-occupied housing stock, which is estimated at EUR 1100 bn[3]. As can been seen from figure 1, the net financial assets of Dutch households are relatively high compared to other European countries. What one should keep in mind is that both the liability and asset sides are large in relation to GDP.

Funding gap

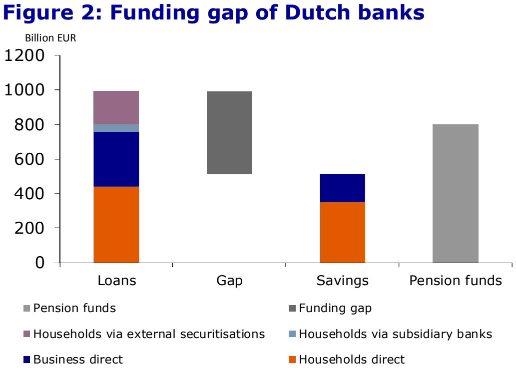
As a result of the high collective (second pillar) pension savings, Dutch households have relatively low banking deposits. Mortgages exceed bank savings by approximately EUR 300 bn. As businesses are net borrowers, Dutch banks are facing a structural funding gap of around EUR

[1] Dalton, M. (2011) *"Mortgage Burden Looms Over Dutch"* The Wall Street Journal, 5 December 2011
[2] Data in this section is from DNB, Q3, 2011

[3] The distribution of assets over the population is not equal to the distribution of liabilities.

500 bn, in spite of the national savings surplus. To fill the gap, banks attract secured and unsecured funding on the capital markets. An important source of secured funding is the issuance of residential mortgage-backed securities (RMBS). Roughly one third of Dutch mortgages are bundled and issued as RMBS. Large institutional investors, such as pension funds, buy these RMBS as part of their investment portfolio. The funding gap can be reduced by decreasing net mortgage debt[4], but funding through deposits remains - due the set-up of the pension system - more difficult in the Netherlands than in other countries.

Figure 2: Funding gap of Dutch banks



Source: Dutch Central Bank

Mortgage product development

The typical mortgage loan has a duration of 30 years, with an interest rate that is fixed for several years (5 or 10 years is common). Mortgage products have been designed to benefit from the tax deductibility of mortgage interest. The Interest-only mortgage, for example, does not involve any type of capital accumulation. By contrast, the Savings, Investment, and Endowment mortgages all include a separate mechanism for capital accumulation[5] as part of the mortgage contract, but the principal remains unchanged during the life of the mortgage. At the end of the 30-year period, enough capital should be accumulated to redeem a substantial part of the mortgage all at once. The Savings and Interest-only mortgages are the most popular type of mortgage, each representing roughly one third of mortgages contracted in 2010[6].

Underwriting criteria

Banks use a prudent approach in underwriting mortgages. Banks must adhere to a Code of Conduct for Mortgage Financing (Gedragscode Hypothecaire Financieringen - GHF). This code has been in effect since 2007, and has been revised in 2011. The most important consideration is the debt burden in relation to the disposable income. The GHF guidelines prescribe maximum gross housing costs at approximately one third of gross income[7]. This is based on budget guidelines from an independent institute called the National Institute for Family Finance Information (NIBUD). Calculations of the gross housing costs are based on a 30-year annuity loan, and current 10-year[8] mortgage interest rates. This is regardless of the type of mortgage product chosen; i.e. even if the contracted mortgage has lower monthly costs, banks are not allowed to offer a higher mortgage amount. The second criterion is the Loan-to-Value (LTV) at the time of purchase. The LTV is limited to 104% of the market value of the house, plus transfer tax (currently at 2%, down from 6%).

In 2011, the Code of Conduct has been revised and this has somewhat tightened mortgage lending. Importantly, interest-only mortgages are now only allowed up to 50% of the market value of the house, where previously it was possible to finance the entire purchase with an interest-only mortgage[9]. This does not necessarily affect gross mortgage debt, as capital can still be accumulated in a separate vehicle with redemption of the principal after 30 years.

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[4] Through either redemption or capital accumulation
[5] These mortgage-linked savings are tax-free up to EUR 150,000.

[6] TNS NIPO Mortgage Monitor 2011
[7] The bandwidth ranges from 21.5% for lower incomes to 45% for higher incomes. The borrower must be in permanent employment, or produce income records over the past 3 years.
[8] If a longer fixed-rate period is chosen, then the actual rate is applied.
[9] See Dutch Housing Market Quarterly, August 2011

Furthermore, the revised Code of Conduct provides less leeway for making exceptions using the 'Explain' clause. This has led to a lower mortgage amount that banks can provide to first-time buyers with good career prospects.

Risks and remedies

Although on the aggregate level, mortgage debt is more than offset by assets, underlying the macroeconomic data are vast differences between households. On a micro-economic level, we distinguish between three types of risk.

First, the *payment risk* is the risk that households are unable to make their monthly mortgage payments. The code of conduct addresses this risk by applying strict rules for the maximum monthly mortgage charges in relation to disposable income.

Second, there is a *negative equity risk*, which is the risk that the value of the house falls below the remaining mortgage debt. This affects households who use their house for pension savings or who wish to sell their house. (Indirectly, negative equity will hamper the functioning of the labour market by reducing mobility in the housing market). In the Netherlands, mortgage lenders have full recourse on the borrower's other savings and may also seize a portion of the borrower's income stream through a relatively straightforward bailiff procedure. The negative equity risk is reduced by the new code of conduct, as households are no longer able to finance the purchase of a house with a pure interest-only mortgage. In addition, mortgages contracted under the NHG have a built-in insurance when debt remains after forced sales outside of the owner's responsibility.

Finally, the *credit risk* is the lender's mirror image of the household's negative equity risk. For mortgages not covered by the NHG, lenders have to write off the remaining debt in case the lender is unable to pay the debt that remains after sale of the property.

National Mortgage Guarantee (NHG)

An important 'insurance' is the NHG guarantee scheme provided by the Stichting Waarborgfonds Eigen Woningen (WEW). The NHG guarantees full reimbursement to the lender in case the borrower defaults on the mortgage. For this reason, banks charge lower mortgage interest rates for NHG-guaranteed mortgages. This discount is typically around 0.5 percentage point throughout the life of the mortgage. The borrower pays a one-time fee of 0.7 percent of the full mortgage amount.

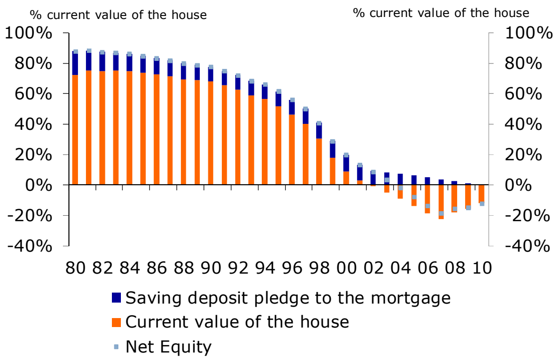
In principle, the NHG is designed to bail out the bank, not the borrower. The borrower remains liable for full reimbursement of the mortgage debt; the only change is that the creditor is now the Association instead of the bank. That said, in case of involuntary sales caused by life events such as divorce, disability, unemployment, or death of the partner, and the borrower has taken all possible steps to limit the financial loss (e.g. selling the house through a real estate agent, in consultation with the lender, to avoid an auction), the Association will cancel debt that remains if the sales price was below the mortgage amount. The NHG expects to settle nearly 2000 claims in 2011, with an average claim amount of EUR 35,000. Based on this claim amount, NHG's reserves of EUR 707 million would be sufficient to bail out 20,000 households.

To qualify for an NHG-guarantee, several criteria must be met, the most important being the maximum mortgage amount. This ceiling was increased from € 265,000 to € 350,000 on 17 September 2009, as a temporary measure to stimulate the housing market. The reversion to the original ceiling will be done gradually over the next three years as follows: on 1-Jul-12 to EUR 320,000, 1-Jul-13: EUR 290,000 and finally on 1-Jul-14: EUR 265,000. Currently around 60% of new mortgages are provided with a NHG guarantee.

Risks: a look at the evidence

Home owners typically start out with negative equity. A model simulation by the Dutch Central Bank (DNB)[10] shows that those who bought a house before 2005 usually have (substantial) positive net equity, but those who purchased their house more recently have negative equity.

Figure 3: net equity based on the year of purchase



Source: Dutch Central Bank

Looking at payment data, the number of arrears and foreclosures has risen during recent years. In June 2011, 0.9% of households had payment arrears of more than 60 days[11]. Only 8% of the arrears finally lead to foreclosure. Foreclosures are currently around 2,500 per year, which accounts for only 0.07% of households with a mortgage. The level remains low, both in comparison to the total number of mortgages and to other countries.

The fact that Dutch households are well able to meet their financial commitments is due in part to the fact that unemployment in the Netherlands is relatively low. In addition, the Netherlands has relatively generous unemployment benefits, which ensure that households do not immediately find themselves in financial distress when they lose their jobs. If unemployment were to increase sharply, or unemployment benefits would be reduced considerably, then more households could be forced to sell. Finally, many Dutch households have taken out mortgages with a fixed-interest period of at least five years. This means they are unaffected by interest rate fluctuations until the time of the re-mortgage.

Conclusion

On a macroeconomic level, risks are not as high as single indicators such as the national mortgage debt suggest. Taking into account financial assets, the picture improves drastically. This holds even more strongly when including unique pension savings. Due to the funding gap, Dutch banks rely heavily on the capital market as a source of funding. Under the revised code of conduct, the funding gap will be reduced by limiting interest-only mortgages. This will reduce the net mortgage debt, but not necessarily the gross mortgage debt. (If capital accumulation rather than redemption is used)

On the microeconomic level, prudent lending practices serve to contain risks for both borrowers and lenders. Nevertheless, the recent fall in house prices has increased risks for those households that purchased a home in the years 2005-2011, with an LTV higher than 100% and financed it with a pure interest-only mortgage. In case of unexpected life events, such as death or divorce, these households will potentially find themselves in financial distress.

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[10] DNBulletin "*Dutch residential mortgage risks unevenly distributed*", 6 December 2011
[11] This represents securitised mortgages; to the best of our knowledge, figures for the market as a whole are not available.