Dutch mortgage market

Impact analysis of new government policies

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- The new Dutch government coalition has announced its policy agenda yesterday. The package includes important measures and reforms targeted at the housing and mortgage market.

- The tax system of mortgage interest deductibility will change. It will be slightly less beneficial to current mortgage borrowers. Mortgage loans originated after 1 January 2013 have to be fully amortising in order to benefit from tax deductibility.

- Reforms in the social security and health care systems could potentially result in higher risks to mortgage servicing behaviour.

- Reforms in the rental market and a plan to tackle to problem of negative housing equity could be beneficial to house prices in the longer run.

- In our forecasts for house prices we already anticipated the announced reforms to a large extent. Regarding the risks related to mortgage servicing, we see somewhat higher risks due to the new measures. However, a material increases in foreclosures and loss rates are not expected.

Introduction

The new Dutch government, consisting of Liberals (VVD) and Social Democrats (PvdA), will likely be installed in office next week. Yesterday, it already announced its policy agenda. The so-called 'coalition agreement', which is the result of weeks of negotiations between the two political parties, includes a broad range of reforms and measures that will impact the Dutch economy and society. This note will focus on the six most important measures that relate to the Dutch housing and mortgage market. For each measure, the impact on house prices and risks related mortgage servicing will be broadly assessed.

1. Lower tax deductibility of mortgage interest payments (existing mortgages)

- *Impact on house prices: slightly negative*
- *Impact on mortgage servicing: very moderate*

The current tax system of mortgage interest deductibility will become less beneficial. The maximum percentage of deductibility (currently 52%) will gradually decrease to 38%, by 0.5% per annum starting in 2014. This is a very gradual change. The measure will only have a modest impact on the housing and mortgage market in our view. Even in the long run, existing mortgage loans will still benefit from a substantial 38% tax subsidy. To compensate for the loss of part of this tax advantage, marginal income tax rates will be lowered. On balance, the net income effects are only very moderate for existing mortgage borrowers. House prices are unlikely to react substantially to this change and risks related to mortgage servicing are unlikely to be affected materially.

2. Lower tax deductibility of mortgage interest payments (new mortgages)

- *Impact on house prices: negative*
- *Impact on mortgage servicing: none for existing borrowers; lower risks for new borrowers*

As already announced, there will be a clear difference between the tax deductibility of existing and new mortgage loans per 1 January 2013. The tax benefit for newly originated mortgage loans will become conditional on a fully amortising mortgage loan. Other non-amortising mortgage products will not enjoy any tax benefits. First-time buyers will be hit hard by this change, since their (net) servicing costs will increase. Since this group has to kick-start demand in the housing market, the consequence of this measure on house prices is negative. The impact on mortgage servicing risks can be neglected for existing mortgage borrowers, since they will be excluded from this change. The servicing risks for new borrowers will decrease, since they will pay back principal during the term of the mortgage loan. This will result in lower loan-to-value (LTV) ratios over time. Whether the tax authorities will be allowed to discriminate between types of mortgage products will be questionable. Some experts have warned that this new tax regime could face substantial implementation risks.

3. Decrease in unemployment benefits

- *Impact on house prices: limited*
- *Impact on mortgage servicing: slightly higher risks*

The system of unemployment benefit payments will become less generous. Currently, the social security system provides a benefit of 70% of the last wage (subject to a cap) in case of unemployment, for a duration up to 38 months. This period will be constrained to a maximum of 24 months per 1 July 2014. A benefit payment of 70% last wage will only be granted in the first 12 months. In the next 12 months, the benefit will be a fixed amount, which will be related to the legal minimum wage. So, both the length and amount of the benefit payments will become less beneficial. Existing unemployed persons will be excluded from the change.

A generous unemployment benefit system is a risk-reducing factor in mortgage loan servicing. Even while the length of the benefit remains substantial, the risks related to mortgage servicing could potentially increase. Older people especially could be affected, since they face in general more difficulties in finding a new job if they become unemployed. An offsetting factor for this group is that they typically have lower LTV mortgage loans. This could limit the loss rate in case of foreclosures. Younger people, with typically higher LTV mortgage loans, are generally less dependent on a long duration unemployment benefit scheme.

4. Increase in health insurance premiums

- *Impact on house prices: negative*
- *Impact on mortgage servicing: higher risks*

Health insurance premiums are split between employers and employees. The latter nominal contribution is currently fixed and equals approximately EUR 1200 per year per person. The fixed amount will be lowered, but an additional, income-dependent, insurance premium will be introduced per 2017. In the budget calculations attached to the policy agenda, this premium is set at 11% of the gross excess income above the minimum wage, subject to a cap of approximately EUR 66.000. For median income households, this change will be broadly neutral. Lower income households will benefit, but higher income households will see (significantly) higher insurance costs.

This change in the health insurance system could hit vulnerable groups in the housing market. Younger people with higher incomes have the largest amounts of negative equity in their houses. The introduction of the income-dependent health insurance premiums will decrease their net income and could potentially lead to higher risks in mortgage servicing from 2017 onwards. Due to the lower disposable income, housing affordability will be affected, so the effect on house prices is negative.

5. Reforms on rental market

- *Impact on house prices: positive*
- *Impact on mortgage servicing: none*

Reforms on the rental market will be quite broad, but are especially targeted at higher income households with (very) low rental costs. A target rental fee will be set at 4.5% of the current market value of the dwelling. The difference between the current (often lower) rental fee and the target will diminish over time. The pace of convergence to the target fee will be conditional on annual income of the tenant. Households with a gross income above EUR 43.000 could be subject to annual increases in the rental fee of 6.5% + inflation. These measures will make the rental market less attractive for high-income earners, which could stimulate the demand for owner-occupied housing.

6. Negative equity

- *Impact on house prices: slightly positive*
- *Impact on mortgage servicing: none*

Negative equity is currently a problem for the housing market. Especially younger households often have a mortgage loan that exceeds the current value of their house. Moving to another house with such a debt burden is difficult. The negative equity has to be closed by own savings or it has to be refinanced. Otherwise households remain 'prisoner in their own house' and moving will be impossible. Refinanced negative equity does not benefit from tax deductibility of the interest paid in the current system. This effect is constraining both the supply and demand side of the housing market. The government will address this problem by making refinancing of the negative equity more attractive. Interest rate deductibility will be extended to negative equity loans, up to 5 years in duration. In general, we assess this measure as slightly positive for house prices.

Conclusion

The measures that the new government to the housing and mortgage market will take will not be without consequences. The limitations to the tax deductibility of mortgage interest payments will make the regime less beneficial in the future, especially for first-time buyers. This will affect housing affordability and has negative consequences for house prices. Positive factors, such as reforms in the rental sector, can only partially mitigate the decline in the price level. In our view, the housing market is already discounting the new reality. In our forecasts for house prices, we already anticipated the policy change to a large extent. At this moment, we foresee little reason to change the -6% (average) drop in house prices for 2012 and the -8% pencilled in for next year.

In terms of mortgage servicing, we see somewhat higher risks. The limitations to tax deductibility and the decrease in unemployment benefits will likely have only a modest impact on servicing. We are more concerned about the increase in health insurance premiums for higher income households in 2017. The most vulnerable group in the housing market (with most negative equity) are young households with relatively high incomes. Mortgage servicing risks for this specific group will increase, although not directly. Cyclical developments will lead to somewhat higher foreclosures rates, which could be fuelled a bit further by these structural changes. The overall loss rates on mortgage loans are not expected to increase materially however. In comparison to other countries, foreclosures rates on Dutch mortgage loans will remain low.

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