ABN·AMRO

Dutch Mortgage Market
Additional Loan Facility

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- The Dutch government has reached agreement with other political parties over another reform package for the Dutch housing market. The consequences for the Dutch mortgage market have remained limited. The new strict rules on new mortgage lending, which require full amortisation over 30 years, remain in force. A new element is the introduction of an Additional Loan Facility.

- In the Additional Loan Facility, mortgage borrowers can take a 'second loan' to finance a part of the principal repayments in an annuity or linear mortgage loan. The additional loan has a zero size at origination and could grow to a maximum level of 50% of the mortgage loan amount.

- The additional loan will be interest-only. As such, the debt dynamics are not different from a combination mortgage involving a 50% annuity and a 50% interest-only loan part. The latter structure is much easier to understand, but does not qualify for tax deductibility of interest payments in the new mortgage regime. The Additional Loan Facility is therefore a rather complicated workaround around the already enacted new tax rules. Interest payments on the additional loan are not tax deductible.

- The introduction of the Additional Loan Facility could result in lower mortgage servicing costs for first-time buyers, which is a positive factor. The lower servicing costs are at the expense of residual debt at maturity of the mortgage. Given the large amount of financial assets of Dutch households, this is not a problem in our view.

- The government has explained the Additional Loan Facility in more detail recently. Still, various practical issues remain unclear. Product development of the loan facility is only in the early stages. In our view, it could take weeks or even months before the product will be offered by mortgage lenders.

- Details of the Additional Loan Facility do matter. The interest rate charged on the additional loan is still uncertain. In order to rule out arbitrage, the government only requires that the interest rate on the Additional Loan Facility is not lower than on the mortgage loan itself. Most important detail will be the degree of optionality for the borrower. This also remains unclear.

- Despite the good intentions, this Additional Loan Facility is unlikely to stimulate demand in the housing market materially. The consequences for Dutch RMBS and covered bonds are not clear yet.

Another reform package for Dutch housing market

Last month, the Dutch government presented a new reform package for the housing market ("Woonakkoord"). In an effort to get the legislation passed quickly, the proposals followed from negotiations between the two parties in the government coalition (Liberals and Social Democrats) and three smaller political parties.

There are significant departures from the housing market policies included in the coalition agreement, but these mainly affect the rental sector. The changes affecting the owner-occupied sector remain limited compared to previously announced reforms and legislation that has already been enacted. The stricter regime for new mortgage loans remains in force[1].

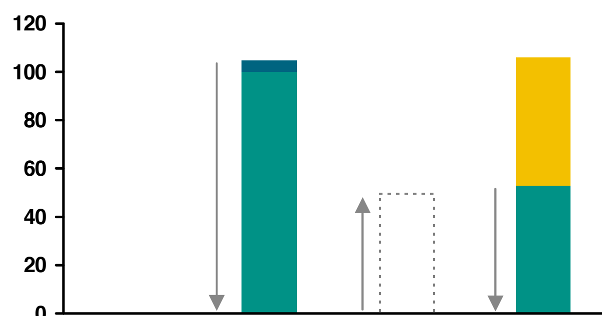
The only new element for the mortgage market is the introduction of an Additional Loan Facility alongside the traditional mortgage loan. Under this voluntary structure, mortgage borrowers can finance a portion of their principal repayments through an additional loan. The measure should reduce borrowing costs for first-time buyers. Unfortunately, the technicalities of this Additional Loan Facility are rather complex and the lack of details led to uncertainty regarding the government's intentions in recent weeks. But on 28 February 2013, the responsible ministers explained the new measure in more detail. Although various practical elements are still unclear, it is interesting to look at the specific loan structure and its consequences. We have doubts about the complexity of the structure, but there are benefits as well. The consequences for Dutch RMBS and covered bonds are not yet clear.

The Additional Loan Facility

According to the reform package, new mortgage borrowers will have the option of taking a 'second loan' in addition to the traditional mortgage. This second loan can be used to finance a portion of the principal repayments for an annuity or linear mortgage loan. The main purpose of this new measure is to lower mortgage servicing costs for first-time buyers, at the expense of a lower redemption on a net debt basis. Although the borrower takes out a new loan to pay off another one, the final outcome is not very different from a mortgage structure involving non-amortising loan parts. Technically speaking, the additional loan is a conditional loan facility or credit line from the bank for the mortgage borrower. At origination of the mortgage loan, the amount in the additional loan facility is zero. As principal payments proceed in the normal mortgage loan, the additional loan could grow in size. The additional loan will be interest-only and will have a maximum maturity of 35 years. Its maximum size is capped at 50% of the value of the underlying mortgage. For example, if the borrower takes out a EUR 200,000 annuity mortgage loan, the maximum size of the Additional Loan Facility is EUR 100,000. The borrower can only draw upon the Additional Loan Facility in order to pay the principal repayments of the amortising mortgage. At the legal maturity of the mortgage (e.g. after 30 years) the mortgage loan itself is fully paid down, whereas the additional loan amount remains. As such, the end result could be equal to a combination mortgage involving 50% annuity and 50% interest-only loan parts.

Structure comparison of the Additional Loan Facility

% LTV*



Structure	Traditional mortgage	Additional Loan Facility	Combination mortgage
Loan(parts)	100% linear/annuity	100% interest-only	50% linear/annuity; 50% interest-only
Interest payments tax deductible?	Yes	No	No**
Maximum maturity	30 years	35 years	30 years
Size at origination	Max. 105% LTV***	0	Max. 105% LTV***
Size at maturity	0	Max. 50% of mortgage loan	Max. 50% LTV at origination

* The arrows reflect the LTV development of the loan over time.
** Per 1 January 2013
*** This LTV cap will decrease by 1% per annum to 100% in 2018.

Example calculations

In order to illustrate the mechanics of the Additional Loan Facility, the government has drafted four sample calculations. We have performed a similar exercise, but in contrast to the government which also incorporates various other housing taxes, we will focus exclusively on the mortgage loan and its servicing costs. The following assumptions are being made.

[1] Our previous publication on 8 February 2013 (Dutch Mortgage Market – The New Landscape) extensively discusses the recent changes and the stricter mortgage regime. Most conclusions in this report are still valid. This publication should be regarded as an add-on.

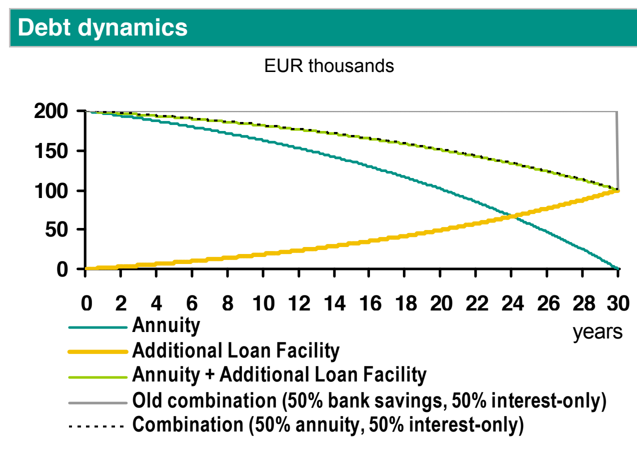
Assumptions in sample calculations

Mortgage (first-lien)	
Loan amount	EUR 200,000
Duration	360 months (30 years)
Interest rate	5% fixed (for 30 years)
Additional Loan Facility	
Maximum amount	EUR 100,000
Duration	Minimum 360 months (30 years)
Interest rate	5% fixed
Borrower	
Marginal tax rate	42%

We assume that the interest rate on the Additional Loan Facility is equal to the mortgage loan. This implies that we regard the additional loan as secured. Later in the text, this assumption will be reviewed.

The Additional Loan Facility could be structured in various ways. According to the government's sample calculations, there is likely some leeway in this respect. Under the most straightforward structure, half of the principal repayments of the mortgage loan are financed through the Additional Loan Facility. The diagram below illustrates this structure.

Debt dynamics



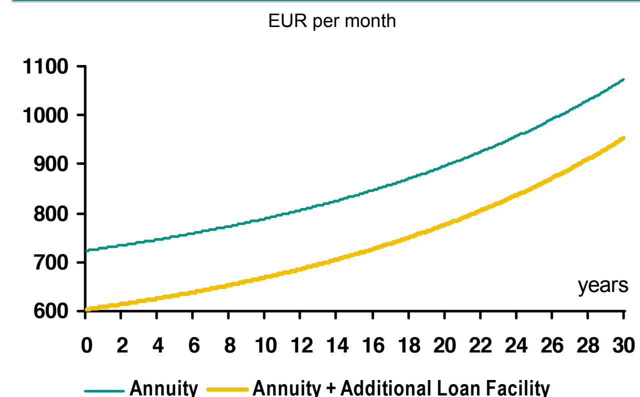
Source: ABN AMRO Fixed Income Research

In this specific example, the borrower takes out a normal annuity mortgage loan, which decreases in size as principal is paid down over time. This is illustrated by the dark green line. Half of all monthly principal repayments are financed through drawing on the Additional Loan Facility. In the diagram, this is illustrated by the yellow line. The additional loan increases from a zero balance at origination to EUR 100,000 in 30 years. Although the additional loan must be separated from the normal mortgage loan for tax reasons, the net debt effect of both loans is illustrated by the bright green line. Net amortisation in this example is half compared to the full annuity mortgage loan.

The other lines describe mortgage loans which are a combination of two loan parts. Under the old tax system, the most common mortgage loan product was a 50% bank savings product combined with 50% interest-only. In this structure, the borrower accumulates capital for repayment of principal in a linked account. At maturity, the capital is used to pay off half of the mortgage loan. This is illustrated by the grey line in the top area of the diagram, which remains constant at EUR 200,000 and than suddenly drops to EUR 100,000 at maturity. The end result is exactly equal to the net debt position of an annuity mortgage combined with the additional loan facility. The dotted line shows a combination mortgage involving 50% annuity and 50% interest-only loan parts. In this case, the net debt situation is exactly equal to the annuity/additional loan combination at any point in time.

All in all, the structure in this example involving the new proposed additional loan structure is not unlike any mortgage loan in which only 50% is being redeemed over time. A very different conclusion applies to the net servicing costs.

Mortgage servicing costs (post-tax)



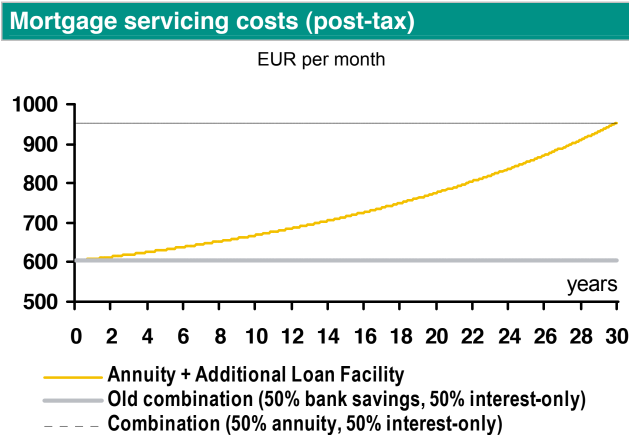
Source: ABN AMRO Fixed Income Research

The net servicing costs for an annuity mortgage loan are relatively clear-cut. The monthly payments to the bank are constant over time. But the composition of interest and principal payments do change over time. As the loan progresses towards maturity, the interest payments decline. This results in a decreasing tax benefit and therefore to gradually higher net servicing costs of the mortgage loan.

Using the Additional Loan Facility can decrease net servicing costs substantially. Also, in this specific example half the monthly redemption payments are financed through increasing the additional loan. Initially, the extra interest charges on this additional loan are marginal. Therefore, the net servicing costs are much lower in the first years after origination. This could be beneficial for first-time buyers. As the interest costs for the

additional loan mount over time, the monthly servicing costs gradually increase. In this example, the monthly servicing costs with the Additional Loan Facility are always lower than if the borrower only takes out an annuity mortgage loan. This effect is mainly caused by a much lower net redemption. In other words, the additional loan creates residual debt at maturity of the mortgage loan.

Mortgage servicing costs (post-tax)



Source: ABN AMRO Fixed Income Research

The monthly net cash flows of the using the Additional Loan Facility are compared to the combination mortgage loans in the graph above. Under the old tax system, which was applicable on all mortgage loans before 1 January 2013, all interest payments were tax deductible and there was no full amortisation requirement. The net servicing costs of the typical 50% bank savings / 50% interest-only mortgage loan are therefore relatively low and constant over time. The grey line in the graph above illustrates this. The annuity / additional loan structure (yellow line) results in roughly similar servicing costs just prior to origination, but the decrease in tax benefit in the annuity mortgage loan and the increase in (non-tax deductible) interest payments in the additional loan do quickly create a marked difference. Therefore, even if the Additional Loan Facility is used, net servicing costs for new mortgage borrowers are higher over time than under the old tax/mortgage regime.

Finally, the net servicing costs for a combination mortgage consisting of 50% annuity / 50% interest-only are included in the graph. If these loan parts are wrapped into one product, it is our understanding that this structure would not qualify for any tax benefit on interest payments whatsoever. Therefore, the net servicing costs are equal to the gross (and constant) payments to the bank. Due to the absence of tax deductibility, this is a very expensive structure. Moreover, 50% of the loan amount is not being redeemed. It is very unlikely that borrowers will select this option. From this perspective as well, using the Additional Loan Facility could be attractive.

Tax system is main reason for complex structure

The question arises why the Dutch government has opted for this rather complicated structure instead of allowing interest-only loan parts in combination mortgages. The answer is related to the tax system. The tax authorities only have the capability of checking whether the mortgage product is fully amortising or not. Only mortgage loans that will fully be redeemed in 30 years will qualify for tax deductibility of interest payments. It is our understanding that any mortgage involving a non-amortising feature will not qualify for tax benefits at all, even if 99% of the loan parts do comply with the full amortisation requirement. Calculation of the interest deductibility on a virtual amortisation basis is not deemed possible. Another reason for the complicated workaround is that the strict tax legislation for new mortgage loans has already been enacted. Any departure from this strict regime would require changes to existing tax legislation, which could be discriminatory to recent mortgage borrowers.

The new strict tax regime could also imply that the Additional Loan Facility will be hard to embed in the mortgage loan structure itself. The government has clearly indicated that netting of cash flows will not be allowed. It is therefore likely that the additional loan will be a separate product alongside the mortgage loan itself. Moreover, the interest payments on this additional loan will not qualify for tax deductibility. Despite this fact, the previous calculations do show that net servicing costs can be reduced substantially compared to an annuity mortgage loan.

Technicalities of the Additional Loan Facility

The aim of creating the Additional Loan Facility is clear: by working around the strict tax system, a 50% annuity / 50% interest-only loan can be replicated in such a way that net servicing costs will be lowered. The next stage will address the practicalities of the complex structure. Details are in fact very important for the functioning of the system. The government has given some indications, but there are also numerous question marks that must be addressed in the product development of the loan structure.

Maturity

The government will restrict the maximum maturity of the Additional Loan Facility to 35 years. New mortgage loans are already restricted to a maximum of 30 years, which implies that there will be a five-year grace period for the additional loan. These 5 years can be used to either pay down the additional loan or, alternatively, to refinance. The (residual) amount of the additional loan can be substantial at maturity of the mortgage. Nevertheless, this is not different from mortgage structures originated between 2010 and 2012, which typically

included a 50% interest-only loan part. From a prudential perspective, 50% non-redemption seems excessive. But in the very long term, a 50% drop in nominal house prices is unlikely. Moreover, Dutch households do hold significant asset base, which mainly consists of fully funded pensions. A complete redemption of mortgage debt, including all costs involved, is therefore probably unnecessary.

Secured versus non-secured

The government's intention is that the Additional Loan Facility can be secured on the underlying property. In other words, the additional loan will be a mortgage in itself. This immediately presents a challenge, because there is already a normal mortgage loan vested on the property. From this perspective, it is likely that the additional loan will be a second-lien mortgage, with subordination to the first-lien annuity or linear loan. It could be that banks will attempt to incorporate the additional loan in the overall mortgage structure (thereby making it first-lien as well), but the tax requirement that the additional loan must be truly separated could be challenging. In theory, the Additional Loan Facility could also be unsecured. But from our perspective, this looks rather unlikely given the sizeable amounts involved.

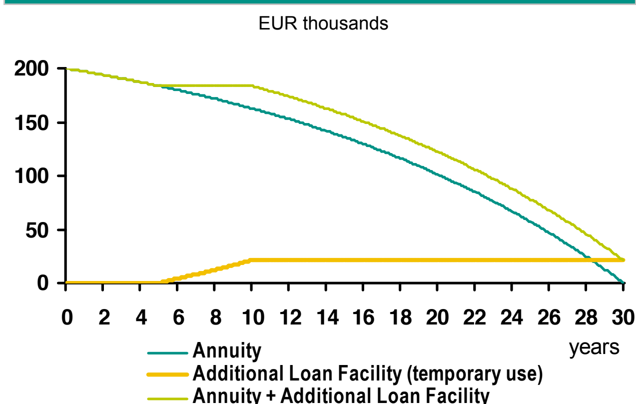
Optionality

Another challenge for product development will be whether the Additional Loan Facility will carry optionalities for the borrower. In the government's explanation, it is stated several times that the structure is completely voluntary. In one of the examples provided, there is a borrower that draws only temporarily from the loan facility.

Offering such a loan facility to mortgage borrowers is not impossible, but it will involve several practical hurdles. As already stated above, the Additional Loan Facility will technically be a credit line from the bank to the mortgage borrower. Such credit facilities are relatively common for banks' corporate customers, but not for consumers[2]. Credit lines imply capital and liquidity costs for banks. Normally, such costs are transferred to the borrower up front or, alternatively, through a mark-up on the interest rate. The structure as provided in the examples above is probably relatively straightforward for a bank. The borrower and the lender can agree on the scheme in advance and both parties will know how loan amounts and servicing costs will evolve over time.

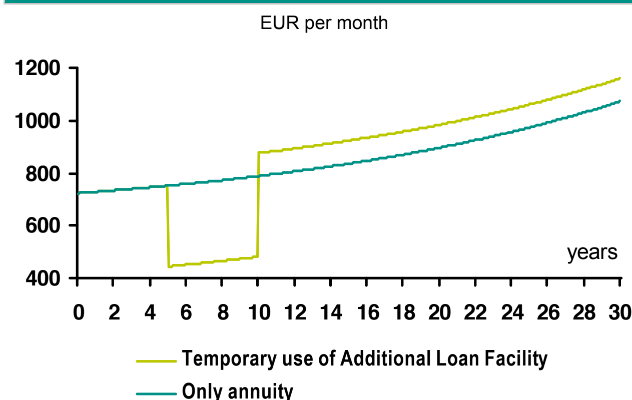
By contrast, if the borrower is given the opportunity to draw on the additional loan facility any time he or she wishes, optionality is already involved. The same applies when the borrower decides to cease using the facility or opts for non-scheduled redemption of the loan amount. The graphs below illustrate a situation whereby the borrower draws on the Additional Loan Facility for all his principal repayments of an annuity mortgage loan, but only for a limited period (from 5 to 10 years after origination). All other assumptions are still being applied in this specific example calculation.

Debt dynamics



Source: ABN AMRO Fixed Income Research

Mortgage servicing costs (post-tax)



Source: ABN AMRO Fixed Income Research

Unfortunately, the government is not very explicit on this issue of optionality. As illustrated above, unpredictability of the usage of the structure could be a serious hurdle in product development.

Interest rate

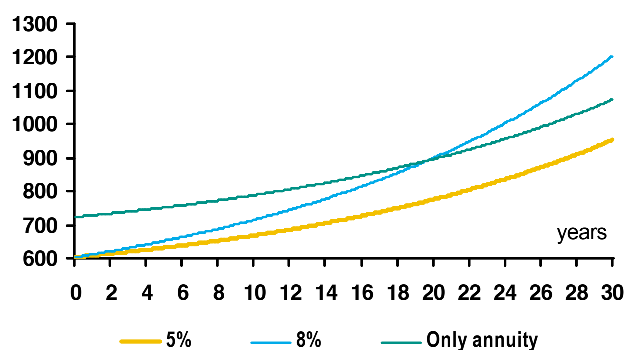
Another important uncertainty relates to the interest rate charged on the additional loan. All other uncertainties are also important in this respect. If the loan will be unsecured, the interest rate will be much higher than on the mortgage loan. A second-lien mortgage could also involve a slightly higher interest rate than a first-lien loan. Moreover, the interest-only characteristics of the Additional Loan facility versus the full

[2] Credit facilities on current accounts can also be regarded as credit lines to consumers, but these are often not as sizeable as for mortgage loans.

amortisation feature of the mortgage loan itself could also involve a mark-up. The government is only explicit about possible arbitrage between the mortgage loan and the Additional Loan Facility. In order to prevent this, the interest rate on the additional loan facility cannot be lower than on the mortgage loan. In our view, this is unlikely to occur in any case. Another challenge relates to the interest rate fixing period. In all the examples above, the interest rate is assumed to be fixed over a period of 30 years. However, this assumption is not compatible with current reality. A typical mortgage has a fixed interest rate period of between roughly five and 15 years. An interest rate reset can, in itself, result in a different annuity structure. For the Additional Loan Facility, a reset in the relevant interest rate could spoil long-lasting structures. Also from this perspective, any optionality in the Additional Loan Facility could encounter practical issues.

All in all, the pricing of the loan product could prove to be a major obstacle. It is most likely that the interest rate for the Additional Loan Facility will be higher than on the mortgage loan, but the devil will be in the details. The relevant interest rate is not just relevant for banks. The higher the interest rate on the Additional Loan Facility, the less attractive it becomes for the borrower. This is illustrated in the diagram below, where the (fixed) interest rate on the facility changes from 5% to 8%.

Mortgage servicing costs (post-tax)



Source: ABN AMRO Fixed Income Research

Consequences for the housing market

The main purpose of the additional loan facility is to lower servicing costs of the mortgage. It is uncertain whether this benefit will also translate into the higher affordability of housing. There are as yet no indications that underwriting criteria will be changed. The current criteria, which are regulated in a special legislation and in the Mortgage Code of Conduct, are enforced in such a way that only people who can afford the costs of a full annuity mortgage loan can obtain such a loan. There are strict limits on the debt (service) to income ratios. Therefore it could prove to be difficult to obtain a larger mortgage loan with the loan facility.

The underwriting legislation makes some exceptions. Borrowers with good career prospects might be granted bigger loans. For this specific group, which must show future income rises in a documented way, the Additional Loan Facility might translate into a bigger mortgage loan amount. However, we doubt that this group will be sizeable enough to make the Additional Loan Facility successful in stimulating demand in the housing market. Moreover, it might be the case that the explicit loan-on-loan structure could discourage usage of the Additional Loan Facility in general.

In our preliminary assessment, the effects of the Additional Loan Facility on the overall housing market will be limited. In the short term, the new measure might even work counterproductively. Product development of the Additional Loan Facility is only in the first stages. It could take weeks, if not months, before lenders will offer this possibility to borrowers. For now, there are still too many uncertainties that have to be addressed. It would not be unreasonable to think that potential borrowers may postpone their purchase intentions. There might be a belief among first-time buyers that the new mortgage framework could reduce servicing costs. But it is not yet available.

Consequences for Dutch RMBS and covered bonds

It is too early to draw firm conclusions for Dutch RMBS and covered bonds. There are too many details missing to enable assessment of the securitisation possibilities of the Additional Loan Facility. In general, a secured loan that increases in size over time might be difficult to put off-balance sheet. Also the optionality could prove to be a major obstacle in this.

If the degree of optionality for the borrower will be limited, it might be the case that the Additional Loan Facility will be embedded in the securitised or ring-fenced mortgage loan. This is will not be very different from the current structures which often involve different loan parts in one mortgage. Problems to the possible second-lien nature of the additional loan can be overcome in our view.

If new securitisations and cover pools will solely consists out of the first-lien annuity or linear mortgage loans, the introduction of the Additional Loan Facility might be credit positive. Regarded from a risk perspective, the extra loan facility could reduce servicing risks on first-lien mortgage loans. This especially applies if the Additional Loan Facility is truly separated from the primary mortgage loan and will rank as second-lien.

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