Commentary

Dutch Residential Mortgage Market Update

DBRS Morningstar
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Introduction

In this commentary, DBRS Morningstar provides an overview of the Dutch housing market as well as how recent events are shaping the trends in the residential mortgage-backed securities (RMBS) transactions with collateral originated in the country.

Dutch house prices have been rising since 2012, with the biggest increases seen in the largest cities such as Amsterdam, Rotterdam, and The Hague. The key factors driving this continuous surge in prices include housing supply shortages, a strong economy, and the lingering low-interest rate environment over the years. While the Dutch economy has so far weathered the energy price shock comparatively well, the recent increase in interest rates has raised risks for the housing market. Data from end-2022 onwards already points to a slowdown in house price increases and even a decrease on a quarterly basis. DBRS Morningstar expects this trend to continue during 2023.

DBRS Morningstar expects Dutch house prices to reverse some of the gains made during the Coronavirus Disease (COVID-19) pandemic. We believe the correction in house prices will be driven mainly by stretched affordability due to rising mortgage rates, but a robust economy and structural housing shortages are likely to limit the downside. It is noteworthy that Dutch house-price increases during the pandemic were amongst the highest in Europe.

The inflation rate in the Netherlands exceeds that of the Eurozone and it currently stands at 8.0%, after September 2022's 14.5% peak, which was driven mainly by higher energy prices. To tame the inflationary effects, the European Central Bank (ECB) started increasing interest rates in 2022. However, higher interest rates have affected new mortgagors, reducing their capacity to borrow. We believe the increased rates together with a cost-of-living crisis will likely cause a slight uptick in mortgage arrears. However, DBRS Morningstar expects that a moderate deterioration in arrears should not affect the stability of Dutch RMBS ratings in 2023.

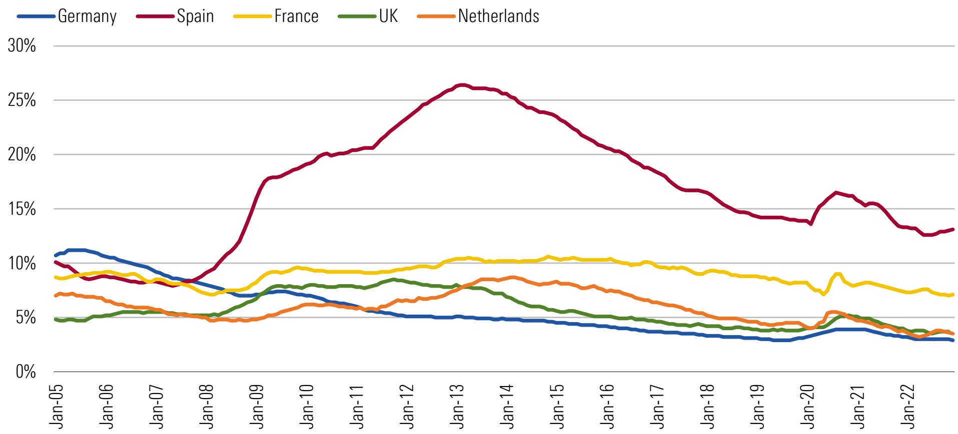
Dutch Economy Overview

Strong economic fundamentals have supported the Dutch economy in navigating the rough waters of the pandemic and the impact of high energy prices. Although economic growth dynamics are projected to weaken, the credit fundamentals of the Dutch economy remain solid. The Netherlands' sovereign ratings remain supported by its highly developed and competitive economy, its strong external position, and high institutional quality. These credit strengths counterbalance the challenges associated with the economy's exposure to external shocks given its high degree of trade openness and the economy's relatively small size. Please refer to *DBRS Morningstar Confirms* *the Kingdom of the Netherlands at AAA, Stable Trend*, published on the 17 March 2023 for additional details.

The pandemic caused significant economic shocks globally. However, the Dutch economy rebounded from the COVID-19-shock much stronger than most other Euro area countries. In Q4 2022, real GDP of the Dutch economy stood 5.9% above its Q4 2019 level compared to an increase of just 2.4% for the total Euro Area.

Growth dynamics in the Netherland over the past few years were supported by strong labour markets.

Exhibit 1 Unemployment Rate Across Selected European Countries



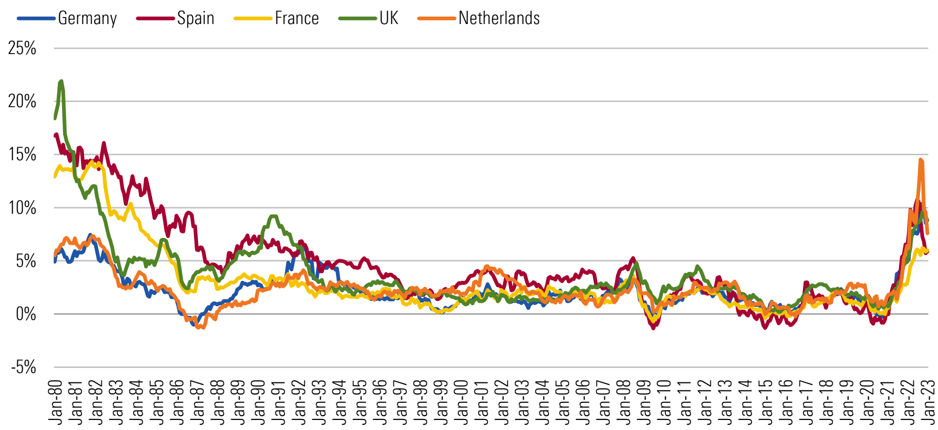
Source: OECD.

According to OECD, the unemployment rate in the Netherlands more than halved to 3.6% in Q4 2022 from its peak in Q1 2014 of 8.7%. However, the descending trajectory appears to have since stalled. As of December 2022, the unemployment rate was 3.5%. As per *DBRS Morningstar's Baseline Economic Scenarios for Rated Sovereigns*, published on 21 December 2022, the unemployment rate is forecast to increase to 4.1% in 2023, which still compares favourably with the long-term average unemployment rate.

Inflation

Higher energy price, particularly that of natural gas, have led to the emergence of a new inflationary environment in Europe unseen in decades: Over the past year, the inflation rate across Europe has varied drastically. Monthly CPI for the Netherlands for January 2023 was 7.6%, which shows a moderation compared with other datapoints in the second half of 2022, particularly in September, when it peaked at 14.5%. However, preliminary figures for February 2023 show that it may have increased relative to January, reaching 8.0%. Compared with the regional peers, the Netherlands has seen one of the highest CPI rates, which has been driven by high energy prices (particularly gas) and the impact of the Russian invasion of Ukraine. Such levels had not been seen in Europe since the 1980s. Core inflation, i.e., excluding food and energy prices, in the Dutch economy is on an upward trend implying that inflation has become more widespread across the consumers' basket of goods and services. More recently, wholesale gas prices have been falling and are now back to the pre-Russia-Ukraine conflict levels, therefore inflation is expected to moderate later in the year.

Exhibit 2 Inflation Rate - CPI (%)

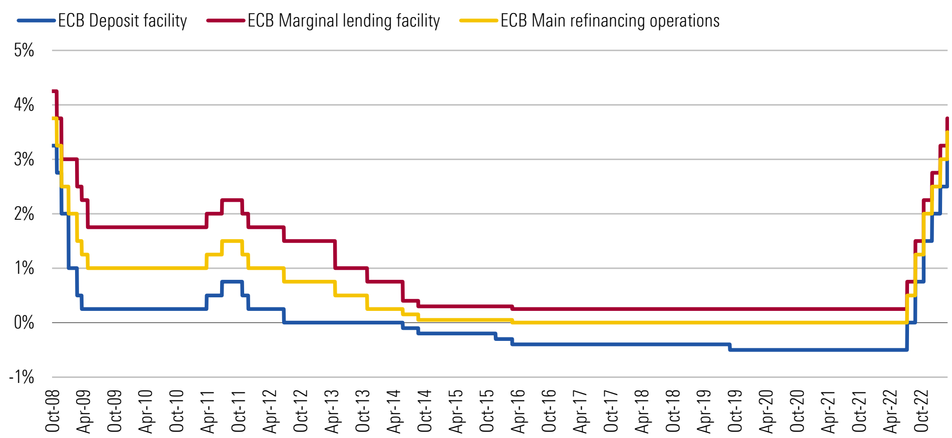


Source: OECD.

Interest Rates

Rapidly increasing interest rates in the Eurozone continue to lag the inflation rate: Since the inflationary pressures felt across the region did not abate as early as expected, the ECB began raising its key interest rates in mid-2022 in order to maintain price stability. From mid-2022 until February 2023, its deposit facility rate has increased by 350 bps, to 3.0% from -0.5%, as of March 2023. The ECB is expected to continue raising the rates, for as long as inflation deviates from its target of 2%, albeit the pace of increases could be reduced as inflation begins to moderate. This is also corroborated by the fact that real rates in the common monetary area continue to be negative. However, recent market turbulences could lead to a more cautious approach by the central bank.

Exhibit 3 ECB Interest Rate



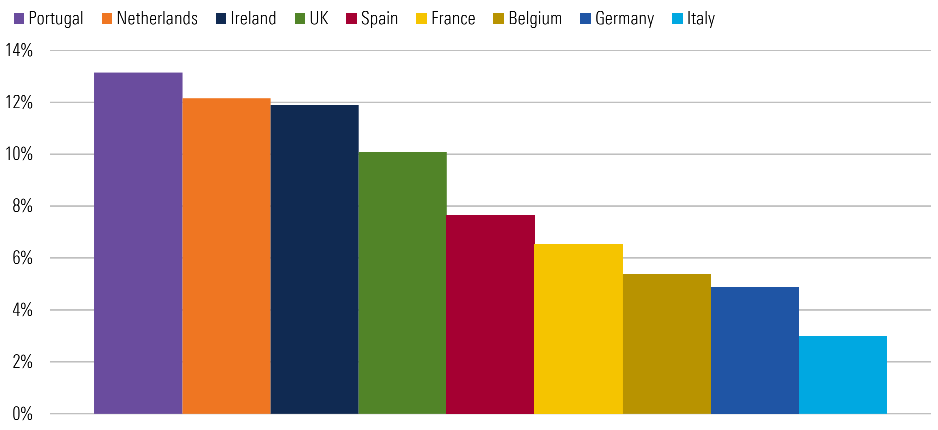
Source: ECB Statistical Datawarehouse.

Residential Property Market

House Prices

The Netherlands experienced one of the largest house price increases in Europe since the onset of the pandemic, but the latest data points to a change in trend: The house price surge during the pandemic had followed a consistently upward trend since reaching a nadir in 2013, registering new year-over-year (YoY) record increases until recently.

Exhibit 4 House Price Growth YoY in Europe - Q3 2022



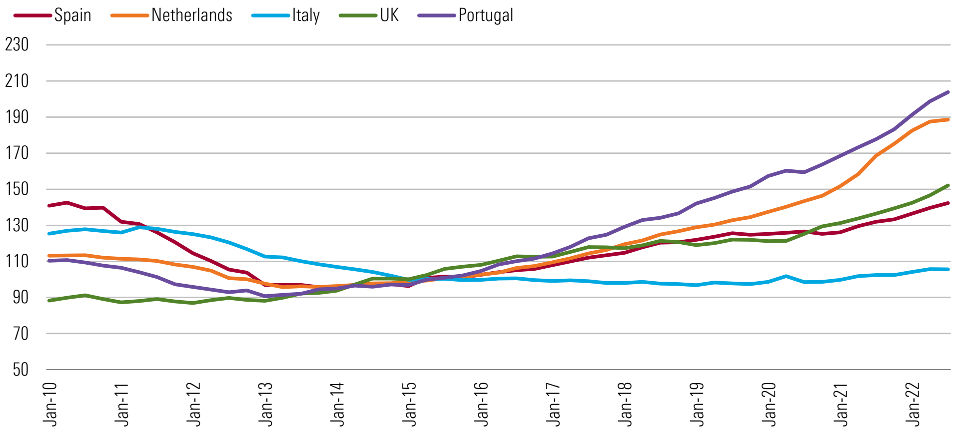
Source: Haver Analytics, Eurostat, Nationwide Building Society.

This robust growth had been fuelled, among other things, by a low unemployment rate and strong economic fundamentals in combination with a shortage in the housing supply. According to the Ministry of the Interior and Kingdom Relations, demand exceeded supply by 279,000 houses in mid-2021[1]. This is one of the main factors that explain the continued rise in house prices, particularly in the major cities. Other factors constraining supply or increasing demand include the previous low-interest rate environment and fiscal policy (mortgage interest deduction). Furthermore, some uncertainties remain in the construction sector particularly surrounding policies to reduce nitrogen emissions, as well as volatility in building costs following the pandemic and supply-chain constraints as a result of government-imposed lockdowns.

There is a strong demand from both the rental as well as the owner-occupier market, which is unmatched by the limited supply. This structural housing shortage in the medium term is likely to provide support to house prices and ensure any house price correction remains relatively contained.

1 Source: https://www.dnb.nl/en/current-economic-issues/housing-market/.

Exhibit 5 House Price Index, Existing Own Homes 2015=100



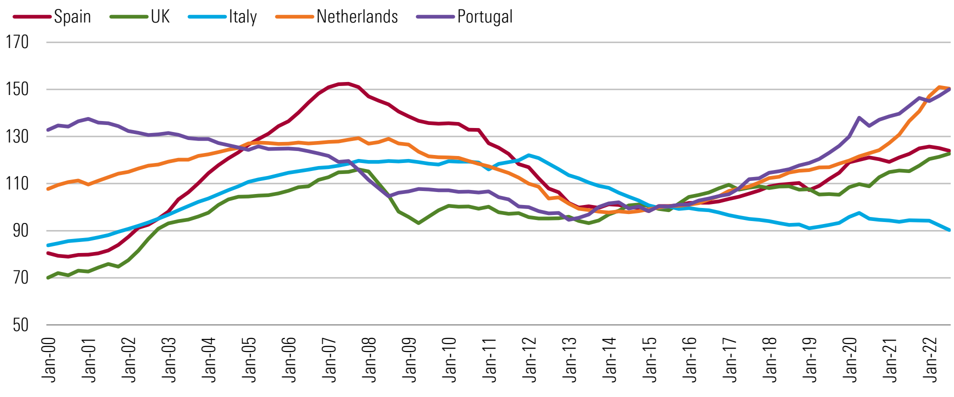
Source: Haver Analytics.

However, house prices appear to be moderating as of the end of 2022. The latest data point as of Q4 2022 shows a decrease vs Q3 2022. Given the challenging macroeconomic context, with high inflation and increasingly higher interest rates, house prices appear to be on the verge of a change of trend. DBRS Morningstar expects a correction in 2023, which will partially reverse gains made since the onset of the pandemic. In the medium-long run, we expect that a positive demand-supply balance for houses would underpin long-term house prices.

Housing Affordability

Affordability constraints for owner-occupier mortgagors to remain despite potential price correction: The Netherlands outpaced most other European countries in house price growth in recent years. As a result, owner-occupied homes became increasingly less affordable, especially for first-time buyers. House price increases have significantly outpaced disposable income growth in recent years. Price-to-income ratios have been exceptionally high, exceeding the previous peak in 2008. Moreover, despite a decade of low-interest rates, house financing costs have risen as the loanable balance increased as well.

Exhibit 6 Price to Income Ratios 2015 = 100



Source: OECD.

This occurred in tandem with a tightening of underwriting standards, given the stricter, post-2008 regulatory framework, which has also made it increasingly difficult for first-time-buyers, many of whom were young, to buy a home. The tightness in the housing market also led to extreme situations in which prospective buyers were increasingly outbidding each other and making offers without viewing or without reservations. According to the largest association of real estate agents and appraisers in the country, NVM[2], as of Q4 2022 about 40% of transactions had a sale price greater than the asking price. Although still a high percentage level, it also points to a reduction in demand in the market (as the increase in interest rates began to bite households' budgets) when compared to the same period a year ago where the level was twice as high.

Nevertheless, even in the case of a potential house price correction, affordability within residential dwellings will remain an issue in the future. This is because while borrowers experience the negative effect of rising rates immediately, the benefits of lower house prices due to reduced demand will only come with a lag in time. In addition, rapidly increasing mortgage rates also imply that the maximum mortgage amounts decrease equally rapidly.

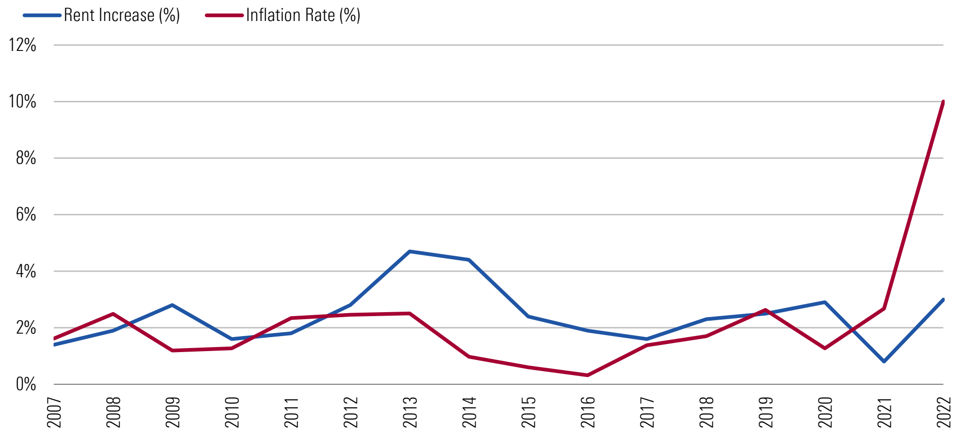
If the drop in house prices were to be more pronounced than expected, there could be a risk that some homeowners enter into negative equity, i.e., that their loan-to-value (LTV) increase above 100%. For current mortgage debt borrowers, however, the impact of rising interest rates on their monthly interest payments is limited by the fact that the majority of the market consists of fixed-rate loans that reset after a relatively long period of typically about five years. Nonetheless, according to the De Nederlandsche Bank's (DNB) Financial Stability Report (Autumn 2022), about a quarter of outstanding mortgage debt interest rate risk will materialise in the shorter term, therefore these households would likely experience a hit to their balance sheets.

Rental Market

The higher rates of inflation pressure renters' income and could stress buy-to-let mortgagors' liquidity, as the government strives to increase supply: Given the difficulties for many individuals to access the housing market, the rental market has seen some increased dynamism over the years. This is particularly reflected in the Randstad region's main cities including Amsterdam, Rotterdam, the Hague, and Utrecht. Data from Centraal Bureau voor de Statistiek (CBS) shows that rent increases by landlords had been consistently above the inflation rate in recent years. However, this trend inverted in 2021 and 2022 following the rapid increase in prices. This could pressure the rental income of landlords and subsequently negatively affect buy-to-let (BTL) transactions as renters are squeezed by a cost-of-living crisis.

2 Source: https://www.nvm.nl/media/gddpeoca/overview-of-the-dutch-property-market-in-the-fourth-quarter-of-2022.pdf.

Exhibit 7 Rent Increase vs Inflation Rate (%)



Source: CBS, OECD.

Approximately 75% of the 3 million rental homes in the Netherlands belong to housing associations. These associations are responsible, among other things, for letting social housing, defined as homes for which the initial monthly rent is under the rent limit for liberalised tenancy agreements. The current limit (2023) is EUR 808.06. Each year, housing associations must let 92.5% of their vacant social housing to people with an income of up to EUR 44,035 (one-person household) or EUR 48,625 (multi-person household) and no more than 7.5% to people with higher incomes than those figures. In some regions the housing shortage is too high for a 7.5% free allocation to suffice. In that case housing associations are allowed to agree to a locally higher percentage of free allocation with the municipality and tenant's association, up to a maximum of 15%.

The Minister for Housing, Hugo De Jonge, submitted a proposal to Parliament to impose an additional maximum to the rent increase until 1 May 2024, which would cap rents by the yearly wage growth plus 0.5%, rather than the inflation rate plus 1% as it is currently. In the social housing sector, a price freeze was implemented following the pandemic until 2024. Given the lack of supply of homes, De Jonge also announced measures to be implemented, including having 90% of all rented homes in the Netherlands falling under the housing valuation system (WWS points), thereby adding homes that are currently in the unregulated sector to the social housing stock.

Dutch Mortgage Market

Mortgage Lending

Recent data shows a tightening of mortgage demand and supply, unseen in approximately a decade, which is consistent with the rapid increase in the cost of debt and deteriorating economic expectations: In the Netherlands, residential mortgages are largely provided by banks, insurance companies, and pension funds. In the past five years, a number of new lenders have entered the market, attracted by good credit performance, standardised products, and the presence of strong intermediaries who help with both the origination and servicing of mortgages. In addition, many insurance companies have launched platforms that allow international investors to invest in Dutch mortgage portfolios.

Even if the past decade has generally been characterised by a good economic environment and credit performance supported by low interest rates, the underwriting criteria of originators has also tightened significantly since the global financial crisis (GFC). This has contributed to risks within the mortgage market being more contained, which provides an important buffer to the expected, limited deterioration in credit performance given the increasing interest rate scenario and cost-of-living crisis. In that sense, it is not surprising to see that residential mortgage loans as a percentage of GDP have declined to 87% as of Q3 2022 from roughly 100% in 2012.

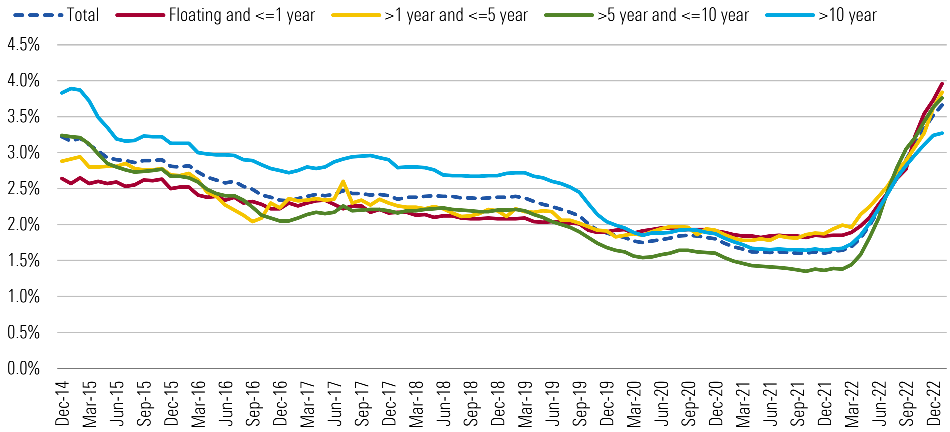
Furthermore, data recently published in the Bank Lending Survey (BLS) conducted by DNB shows that both mortgage demand and supply have tightened considerably in recent months, following the rapid increases in interest rates (which have made borrowing more costly), and a deteriorating economic environment. If we exclude the pandemic period, such a deterioration in sentiment in the mortgage market had not occurred in approximately a decade.

Mortgage Interest Rates

Despite rapid increase in mortgage rates, Dutch borrowers face limited deterioration given majority of relatively long reset periods on fixed-rate mortgages: Dutch mortgage loans mainly carry a fixed rate of interest that is unchanging for a term between five and 30 years. Rate term fixings differ by vintage, with re-fixes carrying the same interest rate as new mortgage loans as per regulation. Record-low rates had provided an incentive for households to refinance their debt with a longer fixed-rate term. However, with a rising rates scenario, this incentive has disappeared, with shorter reset periods being favoured instead.

Prior to the rapid increase in interest rates undertaken by the ECB, Dutch lenders began rising their mortgage rates in accordance with market swaps, thus reacting earlier than the central bank. Since they began rising rates in January 2022 to January 2023 (latest datapoint), mortgage rates have doubled. Given the increase in interest rates on new origination over 2022, interest rates on total outstanding mortgage loans picked up in the second half of 2022, after a long period of a low interest rate environment.

Exhibit 8 Mortgage Rates on New Origination



Source: DNB.

Buy-to-let Mortgages

BTL mortgage market supports placed issuance of Dutch RMBS in recent years, however uncertainties surrounding impact of government measures remain: BTL mortgages, continue to increase in the Netherlands, however, compared to residential mortgage loans Dutch BTL is still a relatively small and underdeveloped market. Only 10% of the total housing stock is classified as 'private sector rent', of which a majority is provided through housing corporations, and a small part by private individuals who are financed through buy-to-let mortgages. For additional insights on this topic please refer to the DBRS Morningstar commentary, *The Dutch Housing Shortage and the Growing Buy-to-Let Market*.

Data from DNB shows that the placed issuance of securitisation of residential mortgages increased in 2021 compared to one year prior, albeit only slightly. According to DNB, the BTL segment was a key driver for both 2020 and 2021 with securitisation more than doubling compared with 2017 and 2018, to over EUR 3 billion. This reflects the growth of the private rental market, and the interest of international institutional investors in the Dutch housing market.

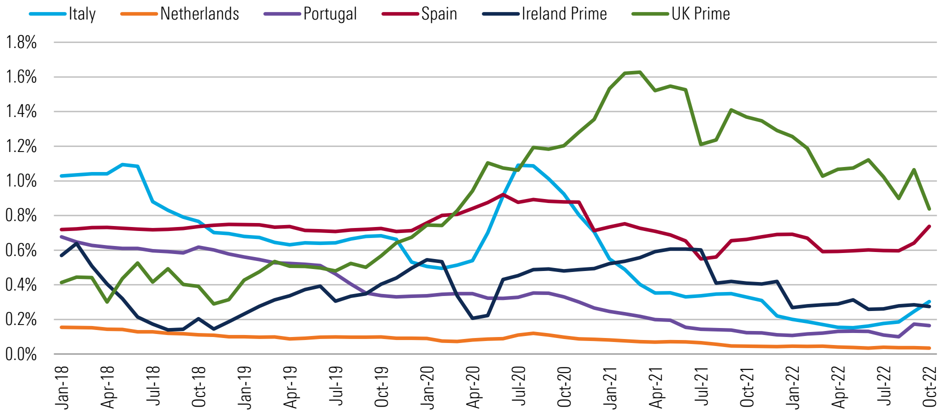
To deter investors from crowding out first-time buyers the government introduced a number of policy changes. Applicable since January 2021, the government reduced to zero taxes on first-time buyers below the age of 35 and substantially increased the real-estate transfer tax on property transactions for investment purposes. As of January 2023, this tax was further increased to 10.4% from 8%. In addition, the local governments of several major cities (including Amsterdam, Rotterdam, The Hague, and Utrecht) have implemented a limitation on BTL purchases for homes with a property valuation up to a certain amount. Moreover, for a period of three years (from 1 May 2021 to 1 May 2024), the law limits the annual rent increase. The maximum rent increase is 1% plus inflation in the previous year, however, as previously mentioned, this may be altered in the near future using the yearly wage growth as a factor instead.

Thus far, despite the aforementioned regulatory changes the Dutch BTL market has continued to grow. However, it remains to be seen if these changes along with other pending national and local government measures, in an environment of rising mortgage rates and a cost-of-living crisis impacting renters, will significantly cool-off the BTL market and reduce investors' interest in this segment.

Dutch RMBS Performance Trends

DBRS Morningstar-rated Dutch transactions continue to perform in accordance with expectations and relatively better than regional peers: While navigating the pandemic without significant upticks, Dutch collateral performance was robust and it was amongst the least affected countries by the pandemic in Europe. Surveillance data shows that arrears greater than 90 days past due remain at very low levels in the Netherlands compared with other countries in Europe. In addition, no rating downgrades have occurred during the past year for issuances out of the Netherlands.

Exhibit 9 RMBS Index for +90 days Arrears Across Europe



Source: DBRS Morningstar.

Looking Ahead

As inflation remains higher in the Eurozone relative to the ECB's target, we expect further interest rate increases before an eventual pause. Given this inflationary setting, the GDP growth of the Dutch economy is expected to slow as households' purchasing power suffers a significant loss as wage raises lag the deterioration in the cost-of-living; due to this, consumer confidence is at its lowest level on record.

The Netherlands has experienced one of the largest house price increases in Europe since the onset of the pandemic. A strong economy, housing supply-demand imbalances, and record-low mortgage rates have fuelled this growth, stretching mortgage affordability. DBRS Morningstar expects Dutch house prices to correct in 2023 due to a combination of factors, including inflation, rising mortgage rates, and the general economic situation.

Although DBRS Morningstar anticipates that mortgage delinquencies will see some increase, it will not worsen significantly, however, as existing borrowers are protected from immediate rate rises due to the relatively long-term fixed-rate nature of Dutch mortgages. Moreover, there is a trend toward variable and cheaper short-term fixed mortgages to avoid locking into currently high rates for longer periods. Dutch mortgage borrowers will benefit from rising nominal wages, built-in property equity, and savings buffers accumulated during the pandemic.

DBRS Morningstar believes that due to inherent structural protections in the RMBS transactions, the expected house price correction and moderate arrears deterioration will not affect the stability of Dutch RMBS ratings in 2023.

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