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More housing market reforms

Philip Bokeloh
Tel. +31 (0)20 383 2657
philip.bokeloh@nl.abnamro.com

On 9 October, the new government presented its coalition agreement, including its plans for the housing market. Cabinet Rutte III wants to implement structural reforms by speeding up the pace of mortgage interest relief reduction. However, its plans for the biggest bottleneck, the housing shortage, remain vague.

New government installed

After a protracted formation period, the Netherlands finally has a new government. With Prime Minister Mark Rutte once again at the helm, the new government consists of four coalition partners: the VVD, CDA, D66 and CU. In their election programs, these parties' views on the housing market varied widely. Nevertheless, they have reached agreement on further structural reforms.

Cabinet to accelerate housing market reforms

Firstly, the government wants to speed up the reduction of mortgage interest relief. The original plan was to decrease the marginal rate at which homeowners can deduct interest rates by half a percentage point – from a maximum of 52% in 2013 to a maximum of 38% in 2041. However, the new government wants to lower the maximum rate by three percentage points from 2020, ultimately reaching 37% in 2023, which is equal to the rate of the first income tax bracket. According to the calculations of the Central Planning Bureau (CPB), this adjustment will lead to a structural cost for borrowers of EUR 0.8 billion.

The new government also plans to raise taxes for people with little or no mortgage debt. In the Netherlands, homeowners are required to add fictional rental income to their income and pay income tax on this so-called *eigenwoningforfait*. However, those with very low mortgage debt (mostly older homeowners) are exempted from this obligation if this fictional rental income exceeds the mortgage interest expenses. This exemption is based on the Hillen Act, which was introduced to encourage mortgage redemption. But nowadays, mortgagors must pay down their loan if they want to qualify for interest relief. Therefore, the government wants to gradually abolish the Hillen Act over the course of thirty years. This will result in a structural cost for homeowners of EUR 1 billion.

Meanwhile, the government is also introducing various tax relief measures. One measure that solely benefits homeowners is the adjustment of the *eigenwoningforfait*. In the future, homeowners with houses valued at up to EUR 1 million will have to add 0.6% of this value to their income, instead of the current 0.75%. Above the EUR 1 million threshold, the rate remains 2.35%. According to the government, the adjustment will lower the income tax burden by an estimated EUR 0.8 billion. This roughly compensates for the structural cost increase linked to reduced interest rate relief.

In addition, income tax rates will fall and the highest tax bracket will start at a higher income level. This will structurally reduce income taxes by EUR 4.3 billion. Furthermore, tax credits will be raised, thus structurally lowering the tax burden by EUR 3.2 billion. The government intends to finance these relief measures by increasing the VAT rate. By doing so, it will collect an additional EUR 2.6 billion. On balance, taxes will decline by EUR 4.9 billion, and not only will homeowners benefit but for all citizens.

Limited effect of measures on price levels

The adjustments are well-timed. The global economy is improving and the Dutch economy is performing well, growing faster than other EU countries. Households feel confident and are optimistic about the prospects for the housing market. Transactions are at a record high and there are signals that the housing market is overheated in several bigger cities. In this context, the reforms were announced at a favorable moment. We expect the price effects to remain limited.

Research by the CPB also suggests that price effects will remain modest. In the run-up to the elections, the CPB evaluated an array of measures, some of which were fairly similar to those currently proposed. For instance, the CPB estimated the price effect of lowering mortgage interest relief by one percentage point a year to ultimately reach 30%. Calculations show that this would lower the structural price level by one percentage point. Phasing out the Hillen Act in four years would reduce the structural price level by 0.8 percentage points. Meanwhile, an increase in the *eigenwoningforfait* of 0.25 percentage point (the opposite of the currently proposed 0.15 percentage point reduction) would lead to a price fall of 1.2 percentage points.

In summary, the price effects of the measures are limited, the more so since some of the measures oppose and outweigh each other. However, the change in mortgage interest relief and lower *eigenwoningforfait* are quite unfavorable for high income groups. Valuation pressures in the higher price segment cannot be ruled out. But chances are small that this will actually happen, since higher income groups will experience an improvement in their purchasing power thanks to lower income taxes.

Reason for the coalition's adjustments

By speeding up housing reforms, the government is agreeing to the demands of international institutions such as the IMF, the OECD and the European Commission. These institutions have been pushing for mortgage debt reduction in the Netherlands. They consider generous mortgage relief as an important cause of the relatively high mortgage debt. According to the latest figures, outstanding mortgage volume amounts to EUR 669 billion. This is 93% of GDP, 11 percentage points below its peak during the crisis.

Another measure being called for by international institutions is a tightening of mortgage restrictions. In recent years, the maximum loan-to-value ratio has been reduced and will reach 100% in 2018. The institutions insist on a further reduction to 90%. But the new government does not concur and is concerned that this would hamper the already constrained market access for first-time buyers.

The new government prefers a different approach to tackling mortgage debt and plans to investigate whether the pension claims can be individualized. This would allow homeowners to use part of their savings for mortgage redemption. Whether the government will be able to introduce individual pension claims remains to be seen, since such a change requires a major adjustment of the pension system.

Additional measures for the housing market

The government wants to improve the quality of the housing stock. At the end of the parliamentary term, most of the newly built houses should be energy efficient. And by 2021, most newly constructed homes should no longer depend on gas. The energy performance standards for new construction will be such that new neighborhoods no longer need to install a gas network.

The existing housing stock will be also become more energy efficient. By 2021, the government wants to renovate 30,000 to 50,000 dwellings annually. Eventually, renovations must rise to 200,000 dwellings a year. If this target is met, the entire housing stock should be gas-free by 2050.

The new government is examining possibilities for private homeowners to finance energy-saving renovations. Lower energy bills could help pay interest and loan redemptions. And if loans could be linked to the dwelling rather than to the mortgagor, this would limit risks for homeowners and improve their access to long-term financing at low interest rates.

What is still missing?

Currently, the Dutch housing market's biggest bottleneck is scarcity. The construction of new homes fell during the crisis and never really recovered. Production is currently at 50,000 dwellings on a yearly basis, which is well behind the required 80,000. According to recent reports, the number of construction licenses is on the increase. However, it is still too small to meet annual demand, let alone catch up with the backlog.

The relationship between demand and supply is traditionally weak. In terms of the price elasticity of the housing supply, the Netherlands is almost at the bottom of the list of the OECD countries. In 2014, the Temporary Committee on Housing Prices led by Kees Verhoeven observed that there is a long time lag between the initial construction phase and the moment of project realization. There are numerous causes for this. Government responsibility for spatial planning is scattered and there are moreover many possibilities to challenge decisions and to appeal to court. Meanwhile, the growing number of parties involved in construction projects increases complexity and leads to further delays.

The realization of projects has become even more difficult since the 'sustainable ladder' zoning tool was introduced during the crisis years. This tool prioritizes construction within urban areas. The new government expects that the new ‘Environmental Act’, which will come into effect in 2018, will make new construction easier. This law gives municipalities more responsibilities and tools to shape spatial zoning and housing policies.

Additionally, the government wants to remove barriers and make arrangements with stakeholders involved in construction. They need to take market changes into account, particularly the rise in demand for affordable housing in the liberalized rental segment. If commercial project developers do not invest sufficiently in this type of housing, housing corporations will be assigned more freedom to locally fill the gap. But corporations’ primary focus remains social housing for lower income groups.

As far as we are concerned, the measures to tackle the housing shortage are not sufficiently specific. Therefore, we doubt that construction output will rise fast enough to meet demand.

Other housing market adjustments

The Guarantee Fund announced an increase in the National Mortgage Guarantee (NHG) cost threshold from EUR 245,000 to EUR 265,000. Given that the loan to value ratio will decline next year from 101% to 100%, the maximum NHG mortgage will increase from EUR 247,500 to EUR 265,000. The maximum for energy-efficient homes will rise from EUR 259,700 to EUR 280,900 as their loan to value ratio remains 106%. As a result, home buyers can insure themselves against the risk of residual debt when buying a more expensive home. However, the increase is comparable to the recent rise in house prices. Therefore, we do not expect NHG’s market share in mortgage lending to rise substantially.

Furthermore, the Nibud mortgage income standards will be tightened somewhat next year. Again, buyers will not be able to borrow as much based on their income. Still, the terms are being loosened for those who borrow on the basis of two incomes. A larger amount of the second income will be incorporated into the calculation of the maximum mortgage amount. Furthermore, buyers will be able to borrow an additional EUR 9,000 if they purchase an energy-efficient dwelling, or upgrade their house to a high energy label. This maximum will rise to EUR 25,000 for homes that are extremely efficient and are energy neutral use no energy at all.

Finally, the Dutch Central Bank is requesting mortgage lenders to actively approach borrowers holding interest-only loans. They need to inform their clients about the potential risks of these loans. More than half of all mortgages are interest-only. As most of these mortgagors bought their homes long ago, very few of them are in negative equity. However, payment issues cannot be ruled out. Firstly, borrowers are likely to face a fall in salary when they retire. Secondly, since 2001 the right to interest relief expires after thirty years. These two events, or a combination of both, could trigger problems, which can be prevented if borrowers start to redeem.

Prospects for the housing market

The new government is reducing the fiscal benefits for homeowners. However, the price effects remain limited. What helps is that the economic circumstances are much better compared to the last time housing market reforms were implemented. In addition, households are being compensated in various ways, such as lower income taxes.

We therefore maintain our price forecasts of a 7.5% increase in home prices this year and 5% in 2018. We note that the housing market is becoming more sensitive to interest rate increases due to the reduction of mortgage relief. However, in the short term we do not foresee a strong rise in interest rates, given the recent announcement by the European Central Bank that it will continue its buy-back program in 2018. This announcement has made a rise in price forecast more likely.

As regards home sales, we continue to expect a modest decline of 5% next year, after an increase of 15% this year. The change in trend is mainly attributable to the shortage in supply. The number of homes for sale has steadily declined as transactions have increased. As a result, buyers find it increasingly difficult to find a suitable home.

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