ABN·AMRO

Covered Bond Watch

Dutch housing & mortgage market Q&A

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- The **Dutch economy** came out of recession in the third quarter of last year, but the outlook remains only one of a fragile recovery. On the one hand, improving global economic conditions, and those in Germany in particular, will be the key driver of the upswing, given the open character of the economy. On the other hand, we expect households to remain reluctant to open their purse strings, preferring to reduce debt rather than to spend. Meanwhile, fiscal consolidation will also limit the strength of the recovery. Overall, we expect the Dutch economy to underperform the eurozone average, although the gap will diminish in 2015.

- The **housing market** passed its trough during the course of last year. We expect that the improvement will continue this year on the back of increased affordability, clarity about the fiscal treatment for homeowners, and the fact that renting becomes less attractive to buying. However, the positives will be partly offset by the slow economic recovery, rising unemployment, as well as stricter mortgage lending rules. In any case, we think that the improvement will be mainly visible in the number of housing transactions, as we not see any noticeable increase in house prices this year, also reflecting still abundant home supply.

- Measures have been taken to make **mortgage lending** more conservative. Only annuity and linear mortgages will be eligible to benefit from tax advantages, while the LTV-cap will be gradually reduced to 100%. Furthermore, the maximum amount that home-buyers are allowed to borrow on the basis of their income has also been reduced somewhat further this year. Consequently, the share of annuity/linear mortgages has risen rapidly to around 70% of new mortgages. Meanwhile, the LTV-ratio has come down as well, although this also reflects that (older) home-buyers that have sold their homes with a profit, use this profit as down payment when they move to another home.

- **Problem loans** are rising, although they remain at relatively low levels. The good payment behaviour mainly reflects a generous social security system, the fact that mortgage lenders have full recourse to the borrower, as well that outside options do not generate a lot of cost benefits.

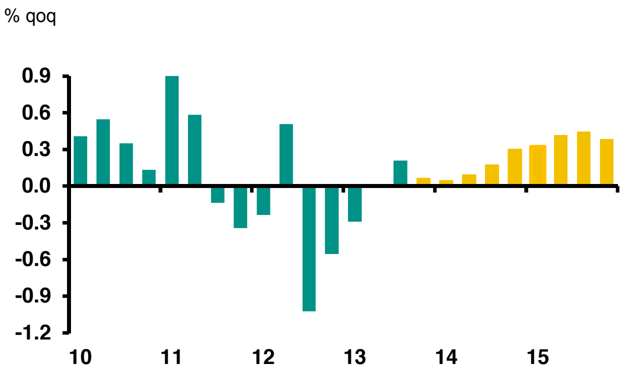
- The impact of the above-mentioned changes have not been visible yet in the **cover pools** statistics of Dutch banks. Instead, the recent drop in house prices has led to an increase in the indexed LTV level. Looking forward however, we expect the quality of cover pools to increase, as LTV-ratios should gradually come down, while the share of classical mortgages is likely to increase, reducing credit risk. But this will be a slow and lengthy process.

- The chances have diminished that the **NHI** will see the light of day, as its aim to reduce the bank funding gap and to lower mortgage interest rates has been taken over by events.

Introduction

The tide is turning for the Dutch economy and housing market. Third-quarter GDP growth was revised slightly upwards, while the Dutch manufacturing PMI is currently the highest within the eurozone. Furthermore, recent data showed that housing transactions are back at pre-crisis levels, as is sentiment. Meanwhile, reforms have been implemented to make the mortgage market more conservative, while rules have also changed somewhat in relation to the use of the National Mortgage Guarantee (NHG). Finally, the National Mortgage Institute (NHI) has not seen the light yet. Please find below a Q&A that addresses most questions related to the Dutch economy as well as housing and mortgage market from a covered bond perspective.

Fig. 1 – GDP growth



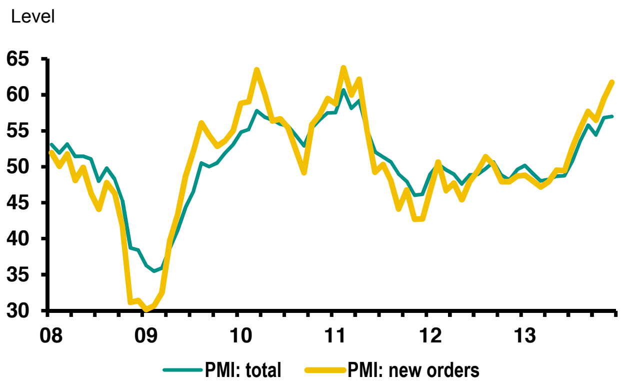
Source: Central Bureau of Statistics, ABN AMRO (forecasts in yellow)

Is the economy out of the woods?

Yes, although the recovery will remain fragile. GDP grew by 0.2% qoq in the third quarter of last year, which marked the end to the prolonged recession that started in early 2011. We expect the economy to continue to grow in the coming two years, with the economy gradually gaining momentum. The key driver of the upswing will be stronger global economic conditions, which should be particularly beneficial for the Dutch economy, with its relatively open character. The strong growth we expect in Germany will be very helpful in this respect, as it absorbs around a quarter of Dutch exports.

Business surveys also paint a brighter picture. The manufacturing PMI stood for instance at 57.0 at the end of last year, up from the 49 area in the first half of 2013. Moreover, the subindex about new (export) orders breached the 60 level for the first time in 32 months. Other business surveys paint a similar picture.

Fig. 2 – Dutch PMI survey



Source: Thomson Reuters Datastream

Consumers have also become more positive (or less negative), with the headline index rising to -12 in January this year, compared to a reading of -32 in September of last year (the long-term average is around -8). Brightening economic prospects have been the main reason for the increase, as households report only a modest increase in their willingness to spend. There is room for the latter to start rising a bit faster, given that household real disposable income will show a modest increase in 2014 after years of decline. Tax measures as well as lower health insurance premiums are the key drivers.

Why will the recovery be a slow affair?

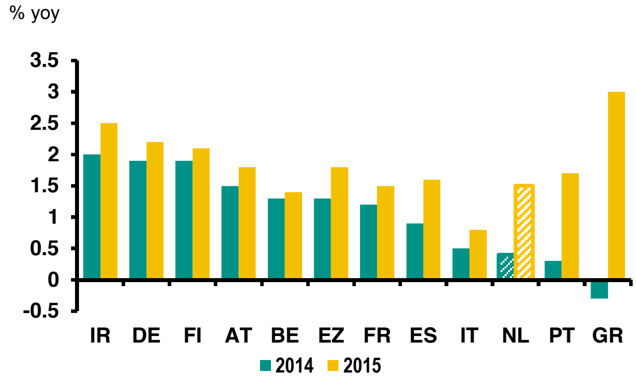
First of all, we expect that households will remain reluctant to spend, preferring to use their increase in purchasing power to reduce (mortgage) debt or increase savings. The fall in house prices has left many homeowners with mortgages that are higher than the value of their properties. For many, making repayments on their home loans is the only way to reduce their negative home equity. The second impediment for growth is ongoing fiscal consolidation. The government has implemented EUR 6 bn (roughly 1% GDP) of extra austerity measures this year, bringing total consolidation to around 2% GDP, which is higher than in most other eurozone countries. Thirdly, most pension funds will keep benefits constant or even lower them, in order to improve their coverage ratio. This will hit purchasing power of pensioners.

How does the Dutch economy compare to the eurozone?

The Dutch economy will in our view lag behind that of most eurozone member states, only outperforming Portugal and

Greece this year. We estimate the Dutch economy to grow by 0.4% in 2014, compared to 1.3% for the eurozone as a whole, and 1.9% for Germany. Next year, growth is likely to strengthen to 1.3% in the Netherland. Although this is still below the 1.8% of the eurozone and our 2.2% estimate for Germany, the gap will narrow in 2015. The factors mentioned in the previous answer explain the underperformance.

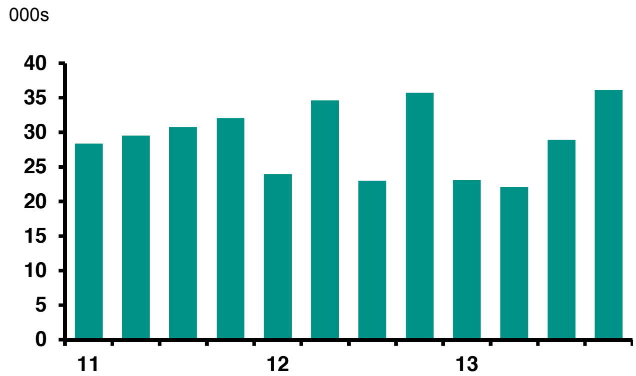
Fig. 3 – GDP forecasts vs eurozone



Source: ABN AMRO

How strong is the upswing on the housing market?
Pretty strong at first sight. The housing market passed the trough during the course of last year. In the second half of the year, we saw a sustained rise in housing transactions, while the pace of decline in house prices softened. Indeed, in the first half of last year, house prices decreased by more than 8% on an annual basis, while this was just above 4% in the second half of the year. Existing home sales increased to 65K in 2013H2, up from 45K in 2013H1. The upswing has gone hand in hand with a significant improvement in the Housing Market Indicator of the Homeowners' Association (VEH), which has risen to 85 in January 2014 (was 51 in December 2012).

Fig. 4 – Existing home sales (quarterly)

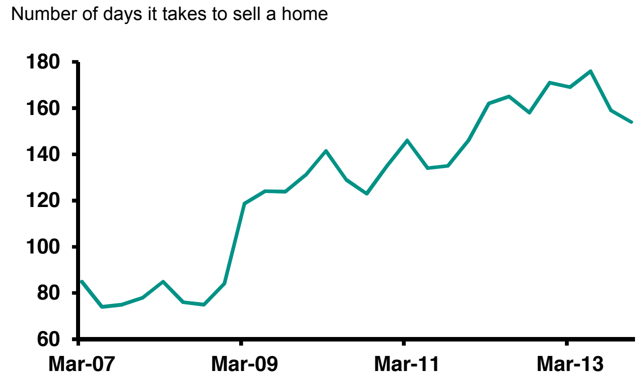


Source: CBS/Land Registry

Will the housing market gain further momentum this year?
We expect the number of transactions to continue to improve, but it will take more time for house prices to recover. Supportive factors are that there will be no new housing market reforms, that there is clarity about the fiscal treatment for homeowners, that affordability has improved, and that renting has become less attractive compared to buying a home. However, these positives will be partly offset by the fragile economic recovery, still rising unemployment, as well as ongoing household deleveraging. Furthermore, the loan-to-value (LTV) cap has been further reduced, while the maximum mortgage loan amount (as measured by the loan-to-income ratio) has also been lowered, resulting in increasing credit constrains. As a result, we do not expect any noticeable increase in house prices this year.

What about the supply of homes?
That is indeed another reason why we think that house prices will not start rising quickly. At the end of last year, there were 162K houses for sale in the Netherlands according to data of the real estate broker association NVM (this translates into 218K houses for the entire market, as the NVM does not provide complete coverage of the Dutch market). The 162K number is less than the peak of 176K at the end of 2012, but still almost twice as much as just before the housing market started to weaken (mid-2008). Indeed, NVM figures show that it took on average 154 days to sell a home in 2013Q4. Although this is down from around 170 days at the start of the year, it is also still well above pre-crisis levels. Overall, these numbers confirm that the market is improving, but at the same time indicate that supply remains abundant, keeping price pressures limited.

Fig. 5 – It takes a while to sell a home

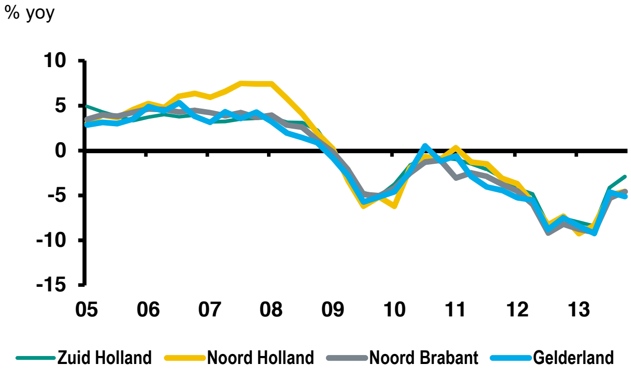


Source: NVM

Do housing market developments differ by region?

Not really. In contrast to what is often believed, the extent of house price declines has been roughly equally spread over the country, with the drop in the peak-to-trough ranging from 18% to 22% in most regions. Only in the province of Zeeland, the decline remained limited to 13%. Having said that, 75% of total housing activity is concentrated in the Randstad region (including the provinces of Noord-Holland, Zuid-Holland, and Utrecht), together with the provinces of Noord-Brabant and Gelderland. Unsurprisingly, these regions also cover the main share of cover pool exposure of Dutch banks, with the exception being SNS Bank, which has a relatively large exposure to the province of Limburg.

Fig. 6 – House prices by region (of table)



Source: Land Registry

Looking at most recent data shows that on a quarterly basis, house prices rose in Q3 and Q4 in Zuid-Holland, while they continued to decline in Noord-Holland, Noord-Brabant, as well as Gelderland. In Utrecht house prices stabilised in 2013Q4. Meanwhile, housing transactions strongly increased in all provinces.

What are the house price forecasts of the rating agencies?

The three main rating agencies have just released updates about the outlook for the Dutch housing market. S&P noted that the slump was over, but that the recovery would only be muted, which is in line with our view. The rating agency expects house prices to stabilise during the course of this year, before rising to 2% in 2015. Meanwhile, Moody's has indicated that it expects property prices to remain broadly flat this year, moving in a range between -3% and +3%. Although Fitch also indicated that it expects house prices to stabilise in the course of 2014, its forecast seems less optimistic under the surface. The reason is that Fitch expects a peak-to-trough decline of around 25%, which would imply that prices still need to drop by a further 6% during the course of this year, which seems unlikely to us.

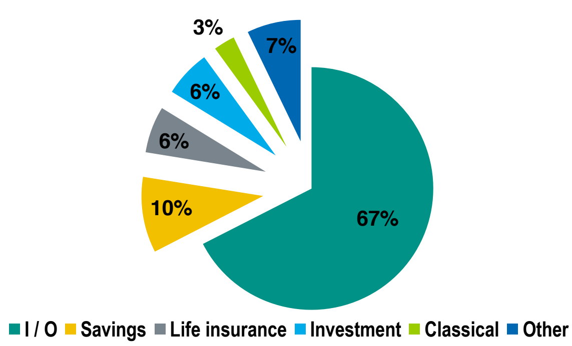
What is the impact of the new rules on mortgage lending?

Mortgage lending will become more conservative. From the start of 2013, only annuity and linear mortgages have been eligible to benefit from tax advantages (i.e. the tax deductibility of mortgage interest payments). Meanwhile, mortgage underwriting criteria have also been tightened. The maximum LTV-ratio will for instance be reduced by 1% a year, from 105% in 2013 to 100% in 2018. Furthermore, the maximum mortgage that home-buyers are allowed to borrow on the basis of their income will slightly decline for the fourth year in a row. Consequently, mortgage lending will be more restraint.

Following the changes, the share of annuity/linear mortgages in total new mortgages has increased from 12% at the end of 2012 to around 70% since 2013Q2. Still 30% of new mortgages are interest-only (I/O), but this can be explained by the fact that in case of mortgage transfer/refinancing, the pervious tax regime remains applicable to the 'old' mortgage amount. Looking forward, we expect that the share of classical mortgages in Dutch cover pools will start increasing, albeit slowly. At the end of last year, I/O mortgages still accounted for two thirds of the cover pools, with the share of classical mortgages ranging between 1% and 5%.

Fig. 7 – Share of mortgage type in Dutch cover pools

Weighted-average share at end of November 2013



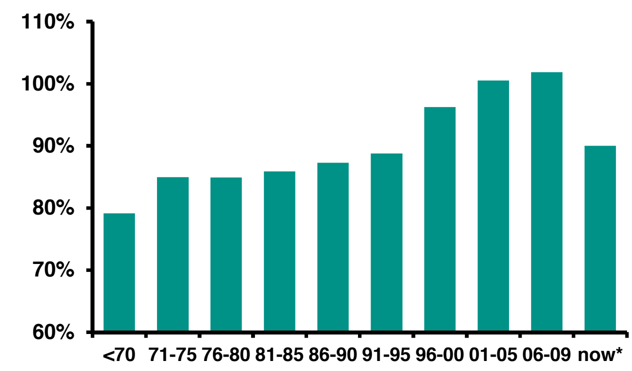
Source: Issuer investor reports, ABN AMRO

Have LTV ratios declined?

Yes. The average LTV-ratio on new mortgages has stabilised at around 90% since 2013Q2, well below the 100% seen in the period 2006-2009. However, this is mainly due to existing (and probably somewhat older) home-owners who used profits on the sale of their homes as down payments when they moved to another home. Having said that, there are signs that stricter lending criteria also exert downward pressure on LTV ratios.

Fig. 8 – LTV ratio declining

% LTV (new mortages)



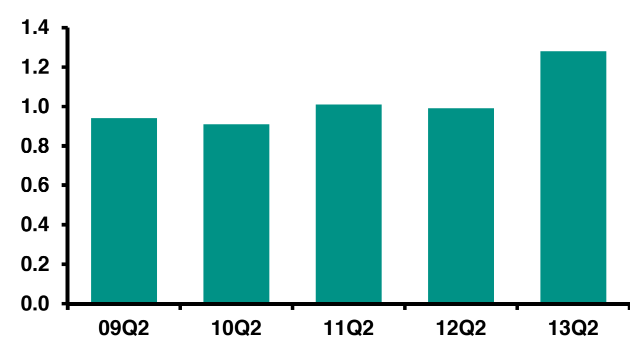
*: This number is based on data from the Hypotheken Data Netwerk, while the other data is based on a household survey of the Dutch central bank. As such, caution should be taken into account when interpreting the data.

Impact already visible in cover pools?

No, this will be a slow and lengthy process, as it takes time before existing high LTV loans will be substituted by new lower LTV loans. Furthermore, the impact of the decline in house prices is currently dominant, having resulted in an increase in the LTV of cover pool assets. The weighted-average indexed LTV was just above 83% in November last year, up from 79% at the end of 2012. Given that we expect house prices to roughly stabilise going forward, combined with more conservative mortgage lending, suggest that we should see a gradual decline in LTV ratios of Dutch cover pools. Nevertheless, the ratio will remain high compared to those in other countries, but this is merely a consequence of the (former) tax system rather than a pure reflection of credit risk.

Fig. 9 – Mortgage problem loans

% of total residential mortgage portfolio



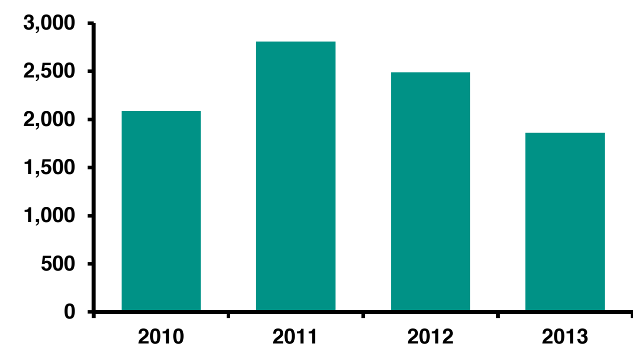
Source: Dutch central bank

Are problem loans rising?

Yes, although they remain at relatively low levels. According to figures from the Dutch central bank, the proportion of problem loans in the total mortgage portfolio was 1.28% in 2013Q2, which was up from 0.94% in 2009Q2. Problem loans are defined as loans in arrears for more than 90 days, and have been closely linked to impairment rates. The limited number of problem loans mainly stems from the generous social security system, the fact that mortgage lenders have full recourse to the borrower, while outside options (i.e. switching to renting) also do not generate large cost savings. Therefore, Dutch households show good payment behaviour related to their mortgages.

Fig. 10 – Foreclosures

Number



Source: Land Registry

Meanwhile, the number of foreclosures has been on a downward trend. In 2013 as a whole, there were 1,863 forced home sales (2% of total transactions), which compares to 2,488 in 2012 (2.3% of total). This is mainly due to the fact that mortgage lenders have become more active in preventing forced sales, as these result in relatively high losses. Looking forward, we expect that the impairments are likely to rise this year on the back of a still fragile economic recovery, rising unemployment, and a depletion of household buffers.

What are the changes to the NHG?

In November last year, the government announced several changes to the National Mortgage Guarantee (NHG), which provides credit protection to home buyers up to a maximum borrowing amount. As of 1 January 2014, home owners that sell their house with a loss will be able to refinance residual debt using NHG, albeit under strict conditions. The current mortgage should for instance already benefit from NHG, while the total borrowing amount might not exceed the maximum borrowing limit (currently EUR 290K). Meanwhile, the residual debt will not be taken into account in the LTV calculation (in fact resulting in an easing of the LTV-cap), but in any case should comply with the loan-to-income rules.

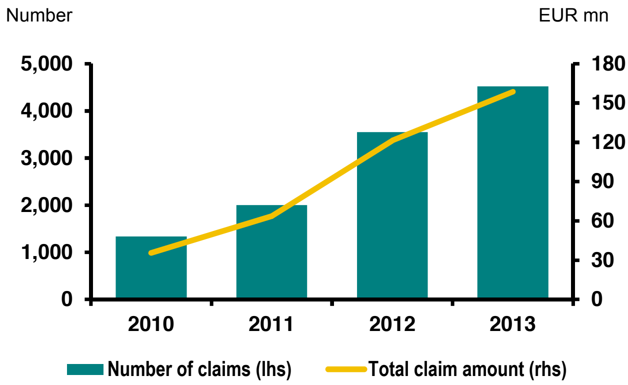
Furthermore, mortgage lenders need to absorb a 10% first-loss on residual debt for new NHG mortgages. However, this is unlikely to result in higher losses at mortgage lenders, as new mortgages are mostly annuity-based, which is already the basis of the loss-compensation calculations of pre-2014 (and mostly I/O) mortgages. Finally, the premium for home buyers to benefit from the guarantee will be increased, from 85bps to 100bps of the mortgage loan.

The government has also announced that the maximum borrowing amount under which a mortgage loan can benefit from a NHG guarantee will be gradually reduced. The current cap of EUR 290K will be lowered to EUR 265K in July 2014, to 245K in July 2015, to reach 225K by July 2016.

What about the use and claims of the NHG?

The big picture is that the use of NHG is on a declining path, while the claim amount is rising. Last year, 9.1% less houses were bought using NHG, although we estimate that the share in total home sales was still around 70%. The main reason for the decline is the reduction in the maximum borrowing amount, while this year the increase in the premium might also have a small impact.

Fig. 11 – NHG claims



Source: NHG, ABN AMRO

Meanwhile, the number (+27%) as well as amount (+31%) of loss declarations increased compared to a year ago. They rose to 4,522 and EUR 158.7 mn, respectively (was 3,548 and EUR 121.4 mn in 2012). This reflects weak economic conditions as well as the decline in house prices. Having said that, with 65%, divorce is the main reason why households have to sell their homes with a loss, as unemployment accounted for 17%.

Looking forward, we do not expect the picture to change this year. The further reduction of the maximum borrowing amount will limit the use of NHG. Meanwhile, rising unemployment, the fragile economic recovery, as well as the increase in household residual debt due to the recent drop in house prices, will result in higher losses. Overall however, think that the financial position of the guarantee fund will be more than sufficient to meet future claims.

What is the latest status of the NHI?

In September, the government announced that it was planning to setup a Dutch Mortgage Institute (NHI), but uncertainty has increased since whether it will see the light of day. The NHI will acquire NHG-guaranteed mortgages from Dutch mortgage lenders, financed by the issuance of state-guaranteed bonds, which should lower bank funding costs as well as reducing the funding gap.

In mid-December, it became clear that the setup of the NHI would be slightly different than previously anticipated. The biggest change was that mortgage lenders will only be allowed to transfer newly produced NHG-mortgage loans to the NHI, while before also existing NHG-guaranteed mortgages were deemed eligible. However, the Dutch Consumer and Markets Authority as well as the European Commission judged that this would provide a competitive advantage to mortgage lenders that already have a large amount of these mortgages on their balance sheet versus new entrants on the mortgage market.

Although at first sight this might result in a less sizeable mortgage bank, limiting its impact, this is not necessarily true. Last year, we estimate that around EUR 20 bn of new NHG-guaranteed mortgages have been extended. This year, this amount is likely to drop a little (see above), but it will most likely remain well into double digit territory. Taking into account that the target size of the NHI is set at EUR 50 bn in five years, there seems to be sufficient room for the mortgage bank to reach this amount.

Meanwhile, the government is still in discussion with the European Commission in order to ensure that the final set-up of the NHI does not involve any state aid, so that mortgage lenders pay a market-based premium to the government for the state-guarantee on the NHI-bonds.

Overall, we think that the likelihood that the NHI will be established have reduced significantly. This is also based on the view that banks can currently attract relatively cheap secured and unsecured funding on the capital markets, while mortgage interest rates have come down strongly as well. As such, it seems that the aim of the NHI to reduce the bank funding gap and to lower mortgage interest rates has been taken over by events.