

DUTCH RESIDENTIAL MORTGAGE MARKET

Compared to other mortgage markets in Europe, the Dutch residential mortgage market is typified a range of relatively complex mortgage loan products¹. Generous tax incentives have resulted in various loan structures. Most of these structures share the common characteristic of bullet repayment of principal at maturity. Historic practices and culture have also shaped the Dutch residential mortgage market in quite a unique way².

Most mortgage loan products reflect the tax deductibility of mortgage loan interest and enable borrowers to defer repayment of principal so as to have maximum tax deductibility. This is evidenced by relatively high LTV values and the extensive use of interest-only mortgage loans (which only need to be redeemed at maturity)³. For borrowers who want to redeem their mortgage loan without losing tax deductibility, alternative products such as ‘bank saving mortgage loans’ were introduced. The main feature of a bank savings mortgage loan is that the borrower opens a deposit account which accrues interest at the same interest rate that the borrower pays on the associated mortgage loan. At maturity, the bank savings are used to redeem the mortgage loan.

In the period prior to the credit crisis increased competition and deregulation of the Dutch financial markets resulted in the development of tailor-made mortgage loans consisting of different loan parts and features, including mortgage loans involving investment risks for borrowers. More focus on transparency and financial predictability have resulted in simpler mortgage loan products in recent years.

Dutch mortgage loans predominantly carry fixed rates of interest that are typically set for a term between 5 and 15 years. Rate term fixings differ by vintage however. Historically low mortgage interest rates in the last decade provided an incentive for households to refinance their mortgage loans with a long-term fixed interest rate (up to as much as 30 years). More recently, a steep mortgage interest rate curve has shifted borrower’s preferences to a shorter rate term fixing⁴. Compared to countries where floating mortgage rates are the norm, Dutch mortgage borrowers are relatively well-insulated against interest rate fluctuations⁵.

Even though Dutch house prices have declined since 2008, the principal amount outstanding of Dutch mortgage loans has continued to increase until the second quarter of 2011. Since then the aggregate outstanding mortgage debt of Dutch households is stabilising. The Dutch mortgage market is still supported by a gradual increase in the levels of owner-occupation and an environment of low mortgage loan interest rates.

Tax deductibility and regulation

Prior to 2001, all interest payments on mortgage loans were deductible in full from taxable income. As from January 2001, tax deductibility was made conditional in three ways. Firstly, deductibility applies only to mortgage loans on the borrower’s primary residence (and not to secondary homes such as holiday homes). Secondly, deductibility is only allowed for a period of up to 30 years. Lastly, the highest marginal tax rate was reduced from 60% to 52% in 2001. However, these tax changes did not have a significant impact on the rate of mortgage loan origination, mainly because of the ongoing decrease of mortgage interest rates at that time.

On top of these limitations that came into force in 2001, tax deductibility of mortgage loan interest payments has been further restricted for borrowers that relocate to a new house and refinance their mortgage loan as from 1 January 2004. Under this new tax regulation (*Bijleenregeling*), tax deductibility in respect of interest on the mortgage loan pertaining to the new house is available only for that part of the mortgage loan that equals the purchase price of the new house less the realised net profit on the old house. Other housing related taxes partially unwind the benefits, but even despite restrictions implied in the past, tax relief on mortgage loans is still substantial. More meaningful restrictions to tax deductibility have been imposed per 1 January 2013 (see recent regulatory changes).

Underwriting standards follow from the Code of Conduct for Mortgage Lending, which is the industry standard. Since 1 August 2011, the requirements for mortgage lending have been tightened by the Financial Markets Authority (AFM). This has resulted in a revised Code of Conduct for Mortgage Lending (*Gedragscode Hypothecaire Financieringen*). It limits the risks of over-crediting. Under those tightened requirements, the principal amount of a mortgage loan may not exceed 104% of the market value of the mortgaged property plus transfer tax (2%). In addition, only a maximum of 50% of the market value of the mortgaged property may be financed by way of an

¹ Due to new regulation, borrowers have been restricted to annuity or linear mortgage loans since January 2013 if they want to make use of tax deductibility. See paragraph “Recent regulatory changes” below

² Rabo Credit Research, Dutch RMBS: a Primer (2013)

³ Dutch Association of Insurers, Dutch Insurance Industry in Figures (2012)

⁴ Dutch Central Bank, statistics, interest rates, table T1.2.

⁵ Maarten van der Molen en Hans Stegeman, “De ongekende stabiliteit van de Nederlandse woningmarkt” (2011)

interest-only mortgage loan. In addition, the revised Code of Conduct provides less leeway for exceptions using the 'explain' clause.⁶ Consequence is that banks are less willing to deviate from the rules set by the revised Code of Conduct. This will make it more difficult for especially first-time buyers to raise financing as they used to be overrepresented as borrowers of mortgage loans subject to an explain clause. In practice, expected income rises of first-time buyers were frequently included, which led to additional borrowing capacity⁷.

Recent regulatory changes

Mortgage loans taken out for houses purchased after 1 January 2013 have to be repaid in full in 30 years and at least on an annuity basis in order to be eligible for tax relief (the linear option is also possible). Tax benefits for mortgage loans, of which the underlying property was bought before 1 January 2013, have remained unchanged. Grandfathering of these tax benefits is possible in case of refinancing and/or relocation. However, any such mortgage loans will again be tested against the Code of Conduct for Mortgage Lending, with the most important condition being that no more than 50% of the mortgage loan may be repaid on an interest-only basis. Furthermore, under a proposal currently pending before Dutch parliament (*Wet maatregelen woningmarkt 2014*) the coalition agreement for the current government, as presented on 29 October 2012, includes measures pursuant to which, as from 2014, the maximum interest deductibility for mortgage loans for tax purposes will decrease for the highest (fourth) tax bracket annually at a rate of 0.5%, from of 52% to 38% eventually.

In addition, the maximum LTV will be gradually lowered to 100% in 2018, by 1% per annum (2013: max LTV: 105% including transfer tax). This guideline has been inserted in special underwriting legislation, which has become effective per 1 January 2013. This new legislation overrules the Code of Conduct for Mortgage Lending currently.

The transfer tax (stamp duty) was temporarily lowered from 6% to 2% on 1 July 2011. With effect from 15 June 2012, it will remain permanently at 2%⁸.

Finally, interest paid on any outstanding debt from a mortgage loan remaining after the sale of a home (negative equity financing) can be deducted for tax purposes for a period of up to 10 years. This measure will be in place from 2013 up to and including 2023.

Recent developments housing market⁹

Existing house prices (PBK-index) rose for the first time in three years on a quarterly basis, albeit by a modest 0.4%. This is in line with the rise in sales numbers. Compared to a year ago, however, prices have fallen (-5%), and by comparison with the peak in 2008, the price drop amounts to 20%.

In the third quarter of 2013, considerably more houses changed hands than in the second quarter. The Land Registry registered a total of 28,925 transactions, which was over 30% more than in the previous quarter. Moreover, the 12-month average rose by over 5% for the first time since 2006.

Forced sales

The number of arrears and involuntary sales of residential property by public auction ("forced sale") in the Netherlands is traditionally very low compared to international standards¹⁰. Especially in the second half of the 1990s, when the demand for residential property was exceptionally strong, house sales by auction, even in the event of a forced sale, almost never occurred or were required. Moreover, the 1990s were characterised by very good employment conditions and a continuing reduction of mortgage interest rates. In the years before 2001, the total number of forced sales was therefore limited compared to the number of owner-occupied houses.

The relatively prolonged economic downturn from 2001 to 2005 led to a significant rise in the amount of mortgage loan payment arrears and correspondingly forced house sales. The number of forced sales in the Netherlands reported by the Land Registry (Kadaster) rose from 695 in 2002 to about 2,000 forced sales from 2005 onwards. This increase was mainly the result of a structural change in the Dutch mortgage loan market during the nineties: instead of selling single income mortgage loans only, lenders were allowed to issue double income mortgage loans. The subsequent credit crisis and the related upswing in unemployment led to a rise of the number of forced sales. The Land Registry

⁶ Under the "explain" clause it is in exceptional cases possible to deviate from the loan-to-income and loan-to-value rules set forth in the Code of Conduct

⁷ M.T. van der Molen, "Aanschaffen woning is makkelijker" (2012)

⁸ Dutch government, Updated Stabilisation Package (2012)

⁹ Rabobank Economic Research Department, Dutch Housing Market Quarterly, June 2013

¹⁰ Comparison of S&P 90+ day delinquency data

recorded 2,488 forced sales in 2012. In the first half of 2013 the number of forced sales amounted to 954, compared to 1301 in the same period in 2012. Recent numbers on forced sales could be distorted by the fact that originators increasingly attempt to circumvent such sales, for example by selling the property in the normal market using an estate agent.

Recent research confirms that the number of households in payment difficulties in the Netherlands is low from an international perspective and that problems mainly have 'external' causes such as divorce or unemployment as opposed to excessively high mortgage debt¹¹.

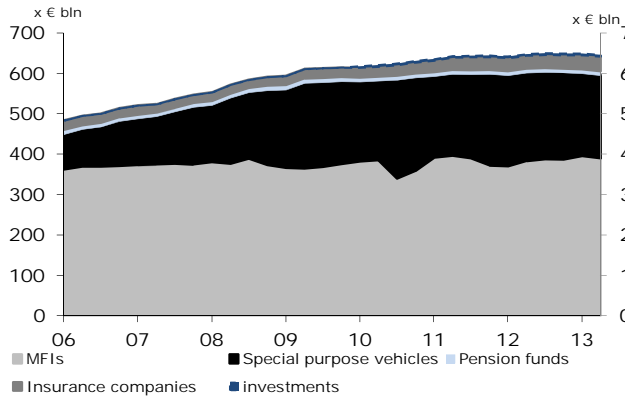
The proportion of forced sales is of such size that it is unlikely to have a significant impact on house prices. The Dutch housing market is characterised by a large discrepancy between demand and supply, which mitigates the negative effect of the economic recession on house prices. In the unforeseen case that the number of forced sales were to increase significantly, this could have a negative effect on house prices. Decreasing house prices could in turn increase loss levels should a borrower default on his mortgage loan payment obligations.

Even though in a relative sense the increase over the last years is substantial, the absolute number of forced sales is still small compared to the total number of residential mortgage loans outstanding. There is no precise data of the number of residential mortgage loans outstanding in the Netherlands. However, based on the published total amount of residential mortgage debt outstanding¹² and the current average mortgage loan principal amount it is estimated that the total number of residential mortgage loans outstanding in the Netherlands exceeds 3 million. A total of approximately 2,500 forced sales per year since 2005 therefore corresponds to approximately 0.1% of the total number of residential mortgage loans outstanding.

¹¹ Standard & Poor's, Mortgage lending business supports some European banking systems (2010)

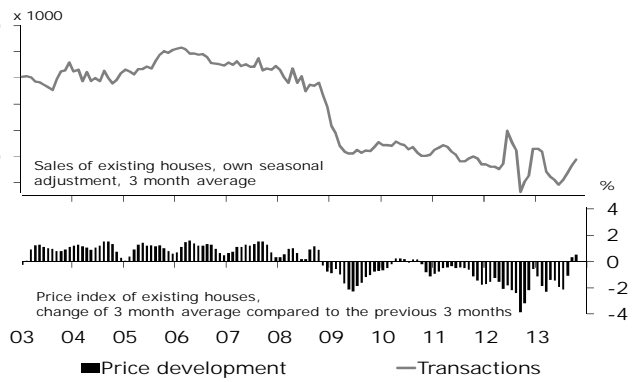
¹² Dutch Central Bank, statistics, households, table T11.1

Chart 1: Total mortgage debt



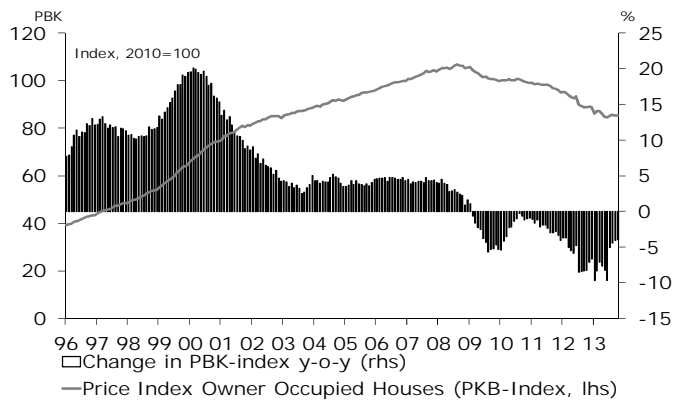
Source: Dutch Central Bank

Chart 2: Transactions and prices



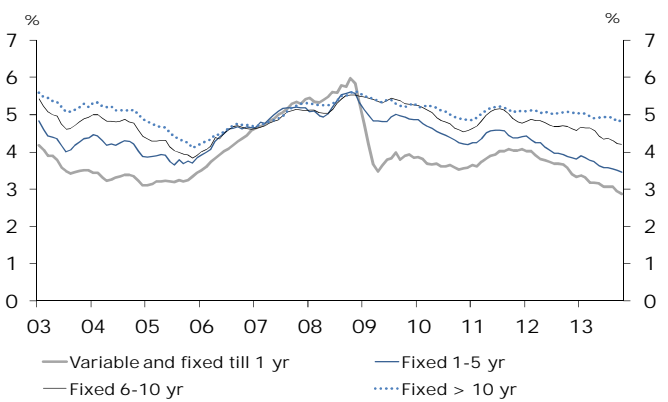
Source: Statistics Netherlands

Chart 3: Price index development



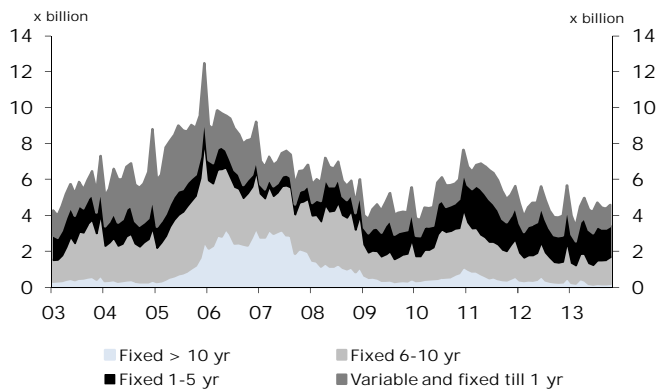
Source: Statistics Netherlands

Chart 4: Interest rate on new mortgages



Source: Dutch Central Bank

Chart 5: Volume of new mortgages by term



Source: Dutch Central Bank