Fixed Income Watch

Group Economics
Macro & Financial Markets

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Insight into Dutch mortgages

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- **Dutch housing market recovery gained pace this year:**
  The housing market has recovered strongly since the trough was reached in June 2013. Prices are now rising by more than 3% yoy, while transactions have increased by 22% so far this year. Currently, some 15,000 homes change owner every month. The recovery has been broad-based across regions as well as type of home.

- **Mortgage origination: shift towards longer maturities and more classical mortgages**
  Mortgage origination has picked up as well, with new production currently outpacing redemptions. Households also prefer to fix mortgage interest rates for longer, while amortising mortgages have also become the norm.

- **Dutch mortgages less risky than often perceived**
  Loan-level-data of the Dutch Central Bank have showed that Dutch mortgages are less risky than often thought. Combining loan-to-value and loan-to-income data reveals that only a small portion of Dutch mortgages have high LTVs as well as high LTIs. Furthermore, full interest-only mortgages tend to be concentrated at older households and at low LTVs. Low mortgage loan losses underline the strong quality of Dutch mortgages.

- **Traditional mortgage lenders losing market share to new entrants**
  Mortgage funding seems in a transitory phase, as traditional mortgages lenders are losing ground. Insures and pension funds have gained market share on the Dutch mortgage market. This mainly reflects regulatory changes, which have left banks at a disadvantage. Therefore, this trend is likely to continue.

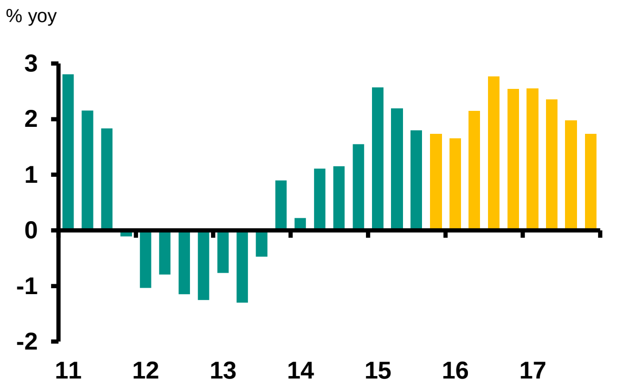
- **Conditional pass-through vs RMBS vs full pass-through**
  Dutch mortgages are partly financed on the capital market by issuance of RMBS and covered bonds. RMBS covers the largest part, but the funding mix seems to be shifting towards covered bonds, These benefit from a more favourable regulatory treatment, while the conditional pass-through structure also narrows the difference in credit enhancement. Soon, full pass-through structure will also see the light of day. RMBS will still remain an important funding source, which could be boosted by new issuance of insurers that gain market share.

Introduction

The Dutch housing market has recovered strongly after reaching a trough in June 2013. House prices have for instance risen by around 7% since the bottom, although prices are still 16% below the peak in August 2008. Meanwhile, the Dutch mortgage market has developed further. The impact of stricter mortgage lending rules as well as increased competition have increasingly become visible. In this respect, a recent study of the Dutch central bank showed that the risk of Dutch mortgages is less than often perceived. Finally, the financing of mortgages seems to be in a transitory phase, as new initiatives have seen the light of day, while traditional mortgage lenders (i.e. banks) are losing ground. In this publication, we provide an update on:

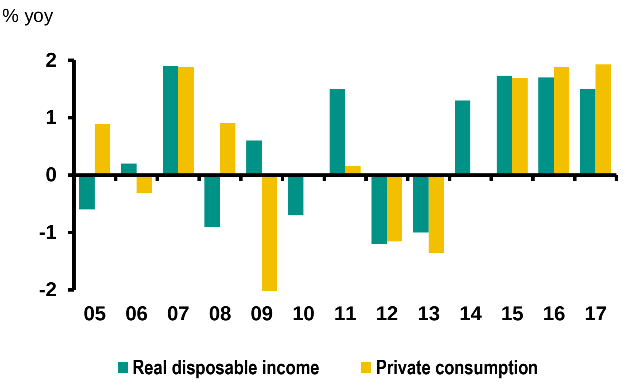
1. The Dutch economy and its fundamentals
2. The housing market
3. The mortgage market
4. Assessing the risk of Dutch mortgages
5. Mortgage funding

GDP growth in the Netherlands



Source: Thomson Reuters Datastream, ABN AMRO

Real disposable income to rise in coming years



Source: Thomson Reuters Datastream, ABN AMRO

1. The Dutch economy and its fundamentals

Sustained economic recovery

The Dutch economy grew by 0.1% qoq in the third quarter compared to the previous quarter, while GDP increased by 1.9% versus the same period a year ago. Overall, growth has become more broad based, with international trade no longer being the only driver of the economy. Domestic demand is being boosted by both consumption and investment. Consumer and producer confidence have returned to elevated levels. Looking forward, we forecast that GDP-growth will accelerate somewhat, from an average of 2.1% in 2015 to 2.3% in 2016.

Overall, the Dutch economy is well diversified and highly productive. GDP amounts to EUR 675bn. Given a population of close to 17 million inhabitants GDP per capita equals EUR 40,000, which is among the highest in the world.

Strong labour market and social security system

The labour market is characterised by a relatively low unemployment rate (6.8%). The participation rate is high (65%), and rising. The social security system is generous. Those that lose their jobs receive a benefit of 75% of the last wage, subject to a capped daily wage of EUR 200. The duration of the benefit depends on the employment history, but can be up to 38 months. Once the unemployment benefit expires, people can resort to assistance support, which ensures an minimum standard of living. Although assistance support is means-tested, homeowners are also entitled to receive a benefit.

Solid pension system

The pension system is robust and consists of three pillars. The first is the mandatory, pay-as-you-go, state run pension scheme. The second is the funded system scheme filled by mandatory contributions of employers and employees. The third consists of voluntary private savings and insurance accounts.

High net wealth

Dutch household net wealth totalled EUR 2,760bn, or 416% of GDP in 2014. Private households financial assets amounted to EUR 2,120bn. These assets comprise accumulated reserves in pension funds and insurance plans. Deposits are relatively limited since the high pension savings reduce the incentive to put (more) money aside. Non-financial assets were valued at EUR 1,450 bn. The value came down substantially after house prices dropped from peak to trough by 22%. From June 2013 onwards, house prices started to recover though.

The bulk of households' debt stock (EUR 800bn) consists of mortgages (EUR 660). Tied to these mortgages are dedicated insurance and investment schemes, which are intended for principal repayment on maturity of the mortgage. These have an estimated value of EUR 60bn, as the exact amount is not known.

2. The housing market

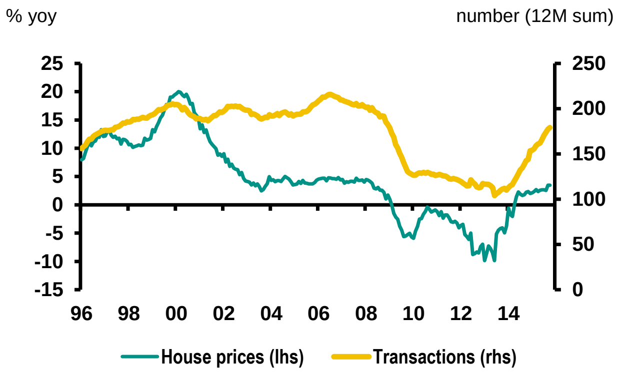
Housing market recovery firming

The housing market has recovered strongly since the trough was reached in June 2013. Recent figures show that house prices rose by 3.4% in October this year compared to the same period last year. Prices increased on average by 2.7% so far this year, which is already close to our year-end forecast of 3%. Overall, house prices have recovered by 6.8% since the trough in June 2013, while they are still down by 16.2% from the peak reached in August 2008. Currently, the level of house prices is comparable to that at the start of 2004.

Transactions jumped

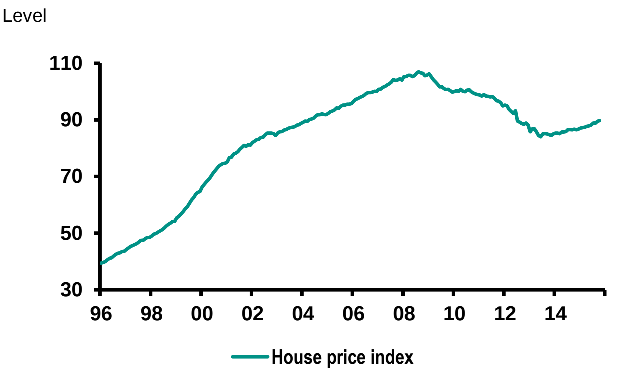
The number of existing home transactions jumped by 39% in 2014 and continued to increase strongly this year. In 2013, an average of 9,175 existing homes were sold per month, while this number rose to 12,793 in 2014, before rising to 14,218 this year. Overall, transactions increased by 22% in the January-October period in 2015, compared to the same period last year. We expect that the year-on-year growth figures will become more modest in coming months, reflecting the waning impact of base effects. Still, even if transactions were to stabilise next year, this would imply that some 15,000 homes will change ownership every month. This compares to 11,000 during the crisis and 17,000 during the boom years.

Dutch house prices and transactions



Source: Thomson Reuters Datastream

Dutch house price index

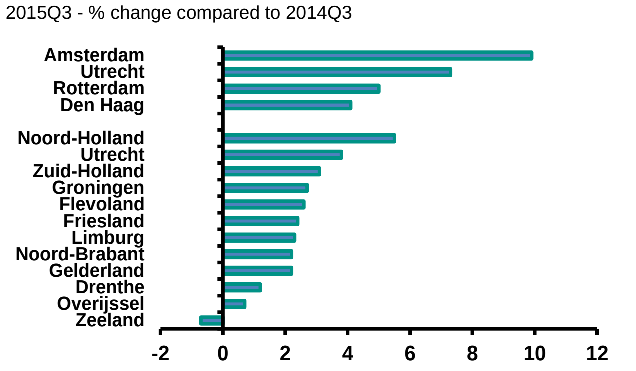


Source: Thomson Reuters Datastream

Recovery is broad-based

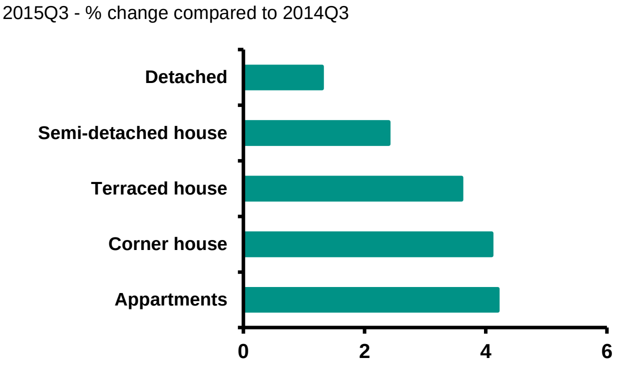
The housing market recovery has been rather broad-based, as sales as well as prices have increased in almost all regions. The only exception was Zeeland, but this region also posted the smallest peak-to-trough decline in house prices. Meanwhile, recent reports suggest that the housing market has showed signs of overheating in Amsterdam. This is underlined by anecdotic evidence that buyers have started to overbid each other in order to buy a home, resulting in homes being sold above the ask price. In any case, the strength of the recovery is stronger in urban areas than in less urban regions.

Dutch house prices by region



Source: Dutch Statistics

Dutch house prices by type of home



Source: Dutch Statistics

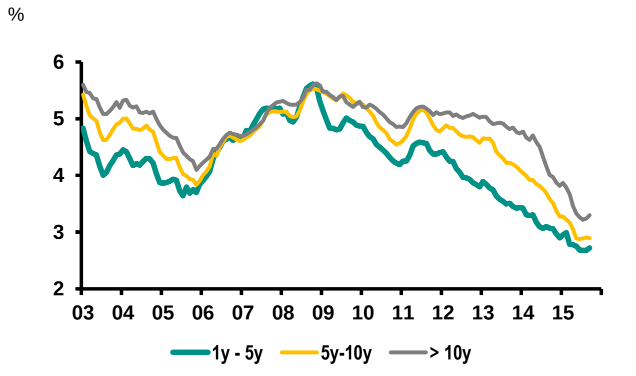
The breakdown by type of home also shows that the recovery has been broad-based. Interesting to note is that prices of more expensive homes have started to pick up recently. This suggests that housing market dynamics are improving, as these houses are mostly bought by non-first time home buyers.

Other signs of improvement are that fewer houses are on the market and that houses are changing hands faster. According to the Dutch Association of Real Estate Brokers (NVM), the properties sold in the third quarter were on the market for 98 days on average, 24 days less than in the same quarter a year ago. The current housing supply is also selling faster: within an average of 337 days versus 395 days last year. The average, incidentally, is significantly inflated by the stock of hard-to-sell properties. According to Calcasa, over a quarter of the housing supply has been on the market longer than three years.

Looking forward

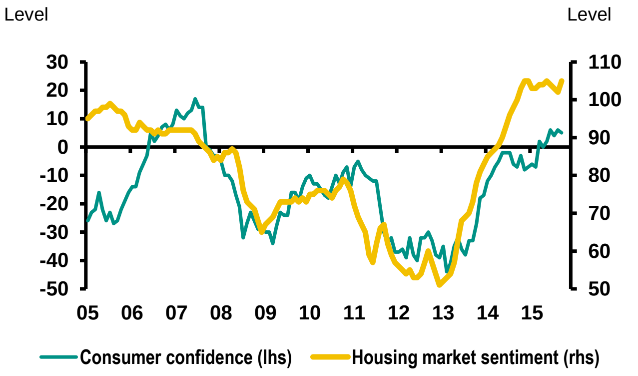
The recovery has mainly been driven by a sharp increase in housing affordability, led by a decline in mortgage interest rates and the past drop in house prices. Furthermore, it has been underpinned by improving economic conditions, and clarity on government measures related to the housing market. Confidence has increased to historically high levels, as measured by the Housing Market Sentiment indicator of the VEH.

Mortgage interest rates of new contracts



Source: DNB

Confidence at historical high levels



Source: Dutch Statistics

Fundamentally, the most important driver of housing demand is the number of households. The current number of 7.5 million is expected to gradually increase because of a sustained rise in population and a continued decline in household size. The number is projected to increase to 8 million in 2020 and 8.5 million in 2040. Meanwhile, the supply of houses is constrained by strict zoning restrictions. Housing supply is one of the most inelastic within the OECD. It is a stock market with few additions and hardly any vacancies. The lack of supply supports the current price rebound.

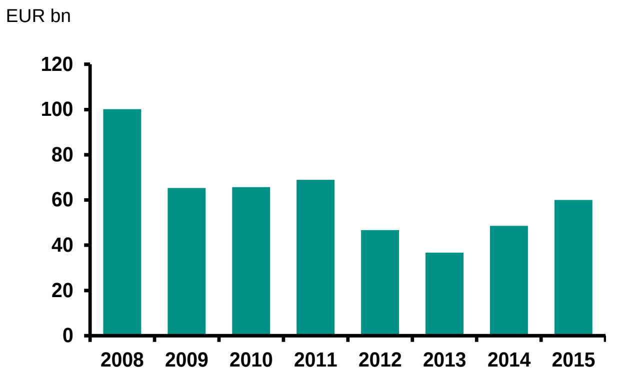
3. The mortgage market

Mortgage origination rising

In line with the developments on the housing market, mortgage origination is picking up after a considerable decline. Before the crisis, mortgage origination reached a peak of some EUR 100bn in 2008, after which it declined to a low of just below EUR 40bn in 2013. We estimate that mortgage origination, which includes both new mortgage lending and refinancing of existing mortgage loans, will rise to more than EUR 60bn this year.

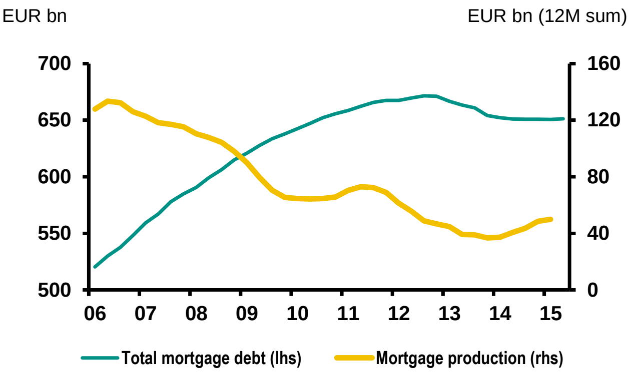
The increase has happened against a backdrop of an ongoing tightening of mortgage lending conditions. An important feature of the mortgage market is the Mortgage Code of Conduct. This code regulates underwriting standards and tries to prevent mortgage credit overextension. In recent years, underwriting criteria have become more conservative. New mortgages need to be amortising to be eligible for a favourable tax treatment (i.e. mortgage interest rate deductibility), while the LTV-limit will be gradually reduced by a yearly 1 percentage point to reach 100% by 2018 (now: 103%). Furthermore, the loan-to-income criteria now take into account future costs for healthcare and parenthood as well as some additional buffers for unforeseen life-events.

Mortgage origination



Source: Land Registry, ABN AMRO

Total mortgage debt



Source: Dutch Statistics, Land Registry, ABN AMRO

Having said that, next year LTI-criteria will on balance be less restrictive for the first time in five years. The picture will be mixed though, as the maximum mortgage amount will continue to decline for lower-income households, while it will increase for higher-incomes. More important will be that double-income households, by far the majority in the Netherlands, will be able to borrow more to buy a home than last year. This is due to the fact that the second (i.e. the lowest) income will count for 50% in the LTI calculation, instead of just a third. Indications are that the count of the second income might rise even further in the future.

Total mortgage debt also edging higher

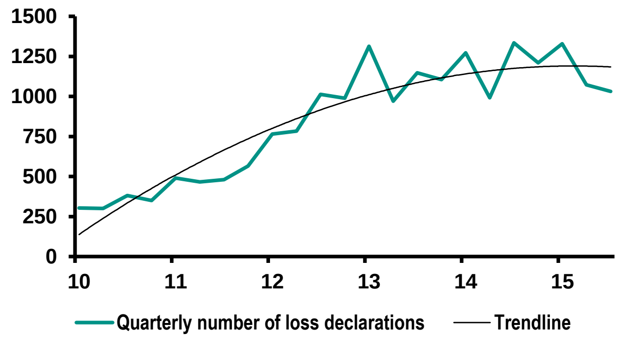
Total mortgage debt (so new origination minus redemptions) has also started to inch up again. In the past few years, redemptions outpaced new mortgage origination, resulting in a decline in total mortgage debt. This was mainly due to households increasingly paying off mortgage debt. The preference to amortize was fanned by low interest rates on saving accounts. Furthermore the government promoted the reduction of mortgage debt by temporarily extending tax incentives for the transfer of gifts to reduce mortgage debt or to finance the purchase of a home. It is worth mentioning that this policy will be reinstalled permanently from 2017 onwards.

NHG guarantee: declining loss declarations

NHG (National Mortgage Guarantee) is a voluntary guarantee system run by the Homeownership Guarantee Fund (WEW) that is backed by local governments and ultimately the Dutch state. NHG offers credit protection to the borrower in case that the borrower needs to sell the property with a loss due to unforeseen circumstances (such as divorce or unemployment). The credit protection covers the residual debt. The maximum amount for which home buyers can make use of the NHG guarantee is currently capped at EUR 245K. On 1 July 2016, this amount will be further lowered to EUR 225K. Furthermore, the NHG guarantee is fully funded by mortgage holders that pay a 1% upfront lump sum fee of the value of the mortgage. In return, mortgage borrowers benefit from lower mortgage interest rates, reflecting lower credit risk for mortgage lenders. Currently, slightly less than half of new mortgages benefit from a NHG guarantee (source: HDN).

NHG guarantee: number of loss declarations

Number



Source: WEW

In total, 1.25 million guarantees have been extended to an amount of EUR 186bn. The Funds' capital buffer amounts to EUR 900mn, which should be sufficient to support future claims. Indeed, the number of loss declarations have started to come down compared to last year (-5% during Q1-Q3), while the average loss amount has also declined. The WEW noted that it seems that the tide is turning for the better, although it is still early days.

Product mix: more classical mortgages…

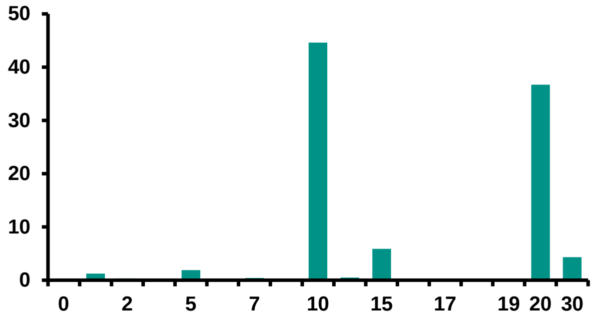
The implementation of stricter mortgage lending conditions has become increasingly visible in the mortgage lending data. By now, less than 50 percent of new mortgages carry NHG protection. In addition the share of annuity based mortgages has increased. due to the tax relief adjustments. According to the Mortgage Data Network (HDN) close to 60% of all new mortgages are annuity based. This means that more and more mortgages are amortising.

…and longer maturities

The typical legal duration of a mortgage is 30 years, equal to the period of tax deductibility for interest payments. However, actual duration of mortgages is much shorter since borrowers move home more frequently and have the option to refinance the mortgage when the interest rate fixing period ends. Interest rates were typically fixed for 5 to 10 years, but recently, an increasing share of new mortgages has a fixed term of 20 or 30 years. In the past ten weeks, around 41% of new mortgages had a fixed term of at least 20 years.

Maturity of fixed-rate mortgages

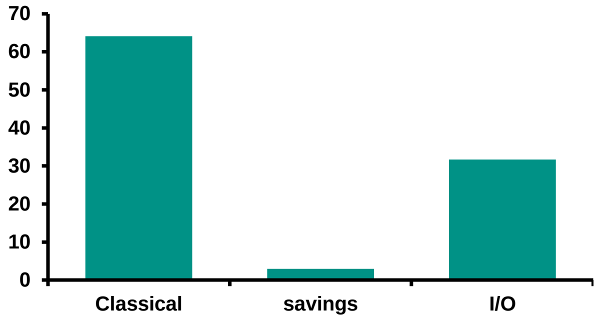
Share in total of mortgage origination in past ten weeks (%)



Source: HDN

Mortgage types

Share in total of mortgage origination in past ten weeks (%)



Source: HDN

4. Assessing the risk of Dutch mortgages

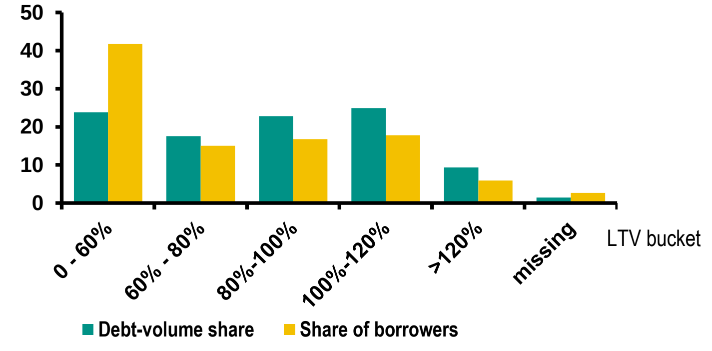
The Dutch Central Bank (DNB) has published a study on the main characteristics of the Dutch mortgage portfolio in October. DNB has used its loan-level data to conduct the study, with nine banks and three insurers providing the data. Overall, the sample covers around 80% of total Dutch mortgages, so it is a good reflection of the total Dutch mortgage portfolio. Below we briefly highlight the main conclusions, which on balance show that Dutch mortgages are less risky than often perceived.

Debt volume and number of borrowers

It is often heard that the credit risk of Dutch mortgages is high, given that they tend to have relatively high LTV ratios. In our view this merely reflects the (former) favourable tax treatment of mortgage interest rates (which are deductible) as well as mortgage savings (i.e. savings accounts that are pledged to repay mortgages at maturity). The DNB study shows the distribution of the Dutch mortgage portfolio by LTV buckets, both in terms of the volume of debt and the number of borrowers. Important to note is that the LTV buckets adjust for pledged saving accounts as far as possible (there is still some data lacking), proving a purer LTV measure. The graph shows that although some 40% of total mortgage debt has a LTV of more than 100% (or are so-called ‘underwater’), this related to ‘only’ 28% of the mortgage borrowers. Hence, DNB concludes that ‘borrowers with higher LTVs tend to have larger mortgages’.

LTV buckets broken down by debt volume and borrowers

Share in total (%)



Source: DNB

However, the loan-level data also include loan-to-income (LTI) figures, which shows that borrowers with high LTVs tend to have low LTIs, which mitigates the credit risk of mortgages with high LTVs. The DNB also combines the information on LTVs and LTIs, which provides an insightful picture of the credit risk of the Dutch mortgage portfolio (see table).

Combinations of LTV and LTI , 2014Q4

	Low LTV Low LTI	Low LTV High LTI	High LTV Low LTI	High LTV High LTI
Proportion of sample (%, original LTV and LTI)	59%	11%	23%	7%
Proportion of sample (%, current LTV and LTI)	67%	3%	28%	3%
Performing loans (%)	98.5%	96.2%	96.7%	95.0%
Loans with arrears (%)	1.1%	2.8%	2.5%	4.1%

Source: DNB

The least risky mortgages have a low LTV (LTV<100%) and low LTI (LTI<5), which tends to be around two-thirds of the Dutch mortgage portfolio. By far the lowest share are the most risky mortgages, which have a high LTV and high LTI. This share even drops to 3% when estimating the current LTV (by using the house price index to calculate the current value of homes) and current LTI (assuming 2% wage inflation per year). The relatively riskiness of the different combinations also comes to the fore when looking at the share of loans in arrears, which is almost four times as high in the high LTV/high LTI bucket than in the low LTV/low LTI one.

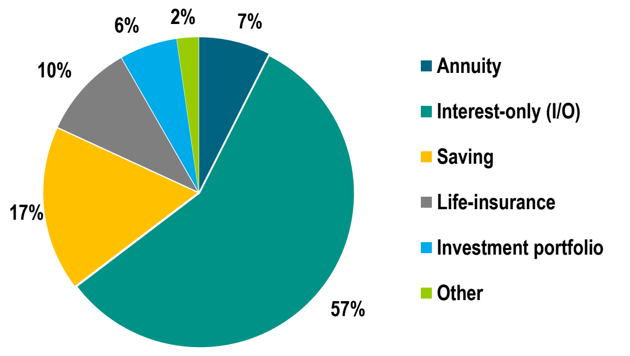
Overall, this part of the study shows that the high LTV ratios in the Netherlands should be interpreted with some care, as a high LTV does not necessarily correspond to high credit risk. Indeed, high LTVs have been compensated for by a low LTI, while the group of borrowers with the highest credit risk remains relatively small.

Interest-only mortgages also less risky than often thought

Another frequently heard thought is that Dutch mortgages are very risky because a large part consists of interest-only (I/O) mortgages. It is argued that this is even worse in combination with high LTV levels. It is true that I/O mortgages bear a relatively high credit risk, and that this risk will be even bigger the higher the LTV ratio. But, the loan-level data of DNB also shed more light on this issue, putting it more into perspective.

Share of loan types in Dutch mortgage portfolio

Share in total debt-volume (%)

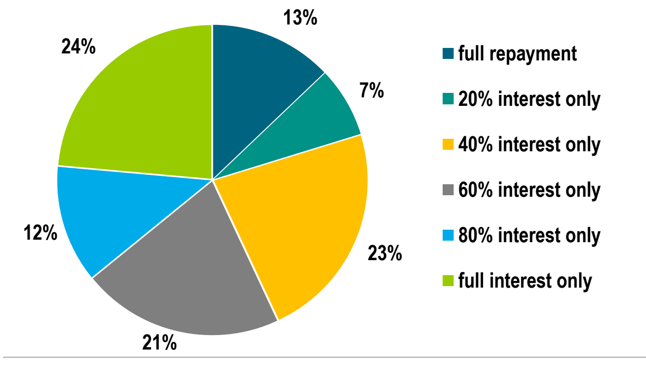


Source: DNB

Dutch households tend to combine different mortgage types when they purchase a home. As a result, mortgage loans often consist of different loan parts. DNB stresses that it makes a difference whether a majority of households have a full I/O mortgage, or that I/O mortgages are spread among a larger group of households. To begin with, the above graph depicts the debt volume broken down by loan type (so per loan and not per household), which confirms the large share of I/O mortgages in the Dutch mortgage portfolio. Indeed, almost 60% of the Dutch mortgage portfolio consists of I/O mortgages, while only 7% are amortising mortgages.

I/O share in Dutch mortgage portfolio

Share in total (%)



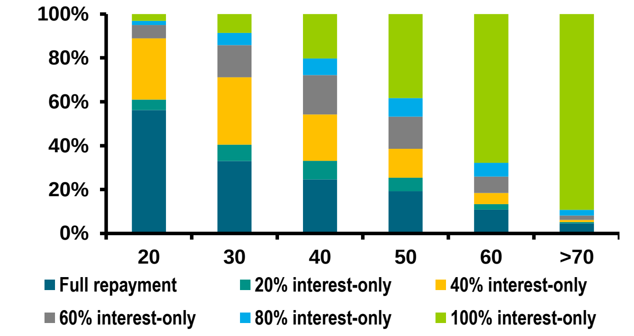
Source: DNB

However, as we mentioned above, most households combine an I/O mortgage with other, more conservative, mortgage types. Therefore, it is interesting to examine the composition of the different loan parts per household. DNB does this by calculating the so-called I/O share of the total mortgage. It defines this of as the share of a borrower's mortgage that consists of an I/O loan. If a borrower has for instance a total mortgage of EUR 150K, which consists for 25K of a savings mortgage, for 50K of an annuity, and for 75K of an I/O mortgage, the I/O share is 50%. If applied to the Dutch mortgage portfolio, it appears that 'only' 24% of mortgage debt consists of full I/O mortgages, while 13% is fully amortising. This shows that I/O mortgages are spread among a large group of households, reducing the credit risk of the total mortgage portfolio.

Drilling even deeper into the figures, it is interesting to see the distribution of the different I/O shares among age groups as well as LTV bucket. This is illustrated in the graphs below, with the colours matching those of the above graph. It turns out that most younger households have low I/O shares, with even 56% having fully amortising mortgages. This is in line with the implementation of stricter mortgage lending criteria in recent years. In contrast, older borrowers tend to have the largest I/O share, with 89% of borrowers aged 70 or older having fully I/O shares. This implies that this age group has the biggest credit risk.

I/O share by age group

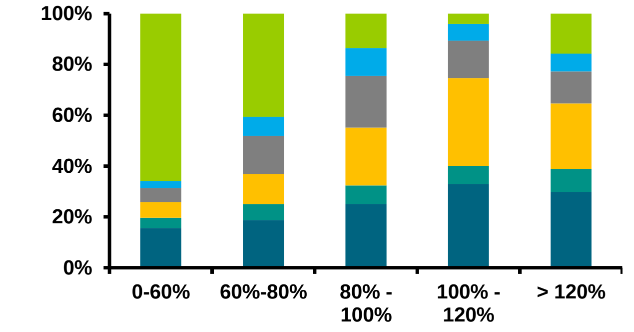
Share in total (%)



Source: DNB

I/O share by LTV bucket

Share in total (%)



Source: DNB

But the picture becomes even more nuanced when looking at the I/O share in relation to the different LTV buckets. Indeed, the loan-level data show a negative correlation between the I/O share and the LTV ratio, i.e. the higher the I/O share, the lower the LTV ratio.

Combining both graphs leads us to conclude that most full I/O loans have been lent to older borrowers, which have mortgages with a relatively low LTV ratio. So, in case that the borrower cannot meet its mortgage payment obligation, it is likely that losses will remain limited. Moreover, the figures seem to reflect that back in the old days, many borrowers took out a second mortgage to cash excess value of their homes (mostly I/O mortgages), while at that time, they also still benefitted from full tax deductibility of all mortgage interest payments.

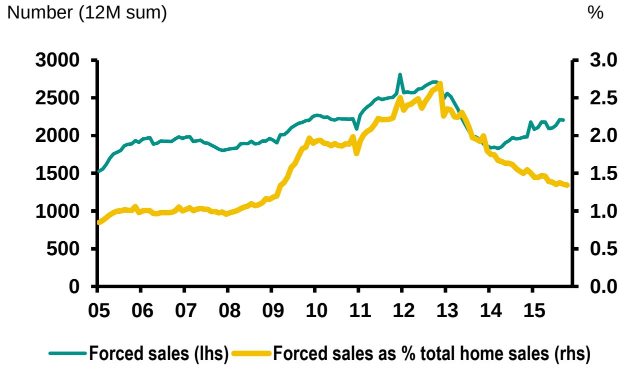
Overall, we think that the breakdown of the I/O share of Dutch mortgages adds evidence that the risks of the Dutch mortgage portfolio is less than often perceived.

Mortgage arrears and defaults relatively low in the Netherlands

The above conclusion has also been underlined by relatively low payment arrears as well as low loss ratios on Dutch mortgages. This is largely explained by the fact that mortgage lenders have full recourse to the borrower. The dwelling, other assets, and even future income of the borrower all count as collateral. Another reason for low arrears and loan losses is the labour market, which is characterised by low unemployment, multiple sources of income of households and a generous social security system. Finally arrears are kept in check by coaching programmes set up by creditors. These programmes help homeowners to put their finances in order again.

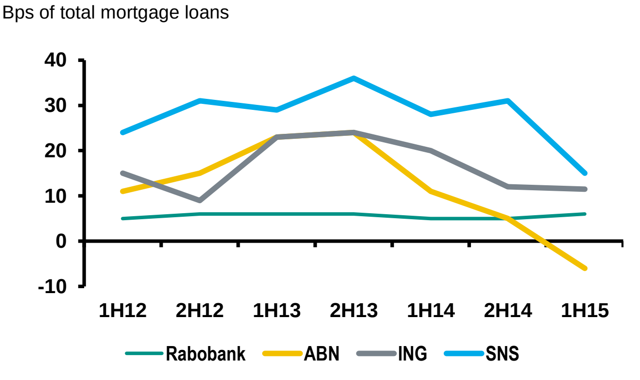
Figures in the graphs below show that forced sales have indeed remained at modest levels. Although the number of foreclosures have risen somewhat, the share in total home sales is declining. Meanwhile, data from our equity research analysts show that Dutch banks have started to reduce their loan-loss provision on mortgages. Moody's data on losses on Dutch RMBS show that loan losses have increased, although they remained limited to only 0.17% of the outstanding balance. Last but not least, DNB published a note recently, noting that that Dutch main banks' large mortgage portfolios are rather resilient, being able to absorb adverse shocks.

Forced sales remain modest



Source: Land Registry, Dutch Statistics

Loan-loss provisions of Dutch banks



Source: Company Data, ABN AMRO Equity Research

5. Mortgage funding

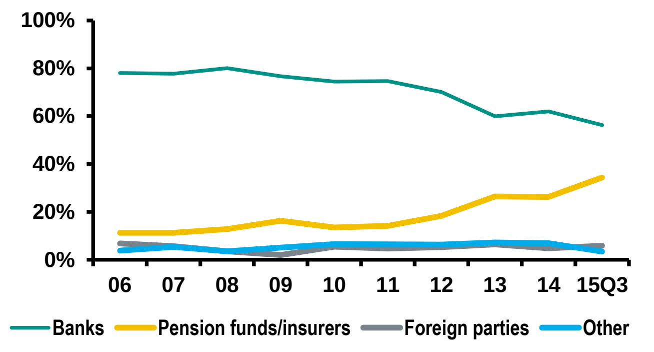
Mortgage funding in transitory phase

The financing means of Dutch mortgages look to be in a transitory phase, as new initiatives have seen the light of day, while traditional mortgage lenders (i.e. banks) are losing ground. There is for instance a shift from banks to insurers and pension funds in mortgage origination. The main banks saw a decline in their share in new mortgage production to below 50% in 2015Q3, which was the lowest reading on record. The market share of Rabobank and its subsidiary Obvion dropped by 3% and 2.2%, respectively, while that of ING bank declined by 2%.

In contrast, the share of insurers and pension funds has continued to increase. According to data from IG&H, their share rose to above 30% in new production in 2015Q3, which compares to below 20% a few years ago. Furthermore, the market share of insurers/pension funds is growing the fastest, while they are even the largest mortgage providers for first-time home buyers. This trend has mainly been driven by (upcoming) regulatory changes, which will put banks at a disadvantage to pension funds/insurers, as banks will face higher capital charges.

Banks are losing market share

Share in total of new mortgage production(%)



Source: IG&H

Attractive margins have also been an important factor at play. As a result, more foreign parties have entered the Dutch mortgage market again, after most of them left during the crisis. These parties mainly focus on first-time home buyers. Meanwhile, funds allocated to dedicated mortgage funds or intermediaries have also risen. Munt Hypotheken, which is funded by some Dutch pension funds, has for instance revised upwards its target for mortgage lending to EUR 10bn (up from EUR 3bn) in coming years.

Additionally, a large Dutch pension fund will start mortgage lending to its own participants, while next year Solid Mortgages will try to get a footing on the Dutch mortgage market by copying the Danish mortgage model. Finally, some banks have indicated that they are willing to sell whole-loans to investors, which is likely to result in a pickup in activity in this particular market.

All in all, recent developments have resulted in increased competition on the Dutch mortgage market, pushing down mortgage interest rates. Looking forward, banks are likely to continue to lose market share, given their disadvantageous regulatory treatment related to mortgage lending versus insurers/pension funds. So, although still 90% of total mortgage debt has been financed by banks, this share will probably drop significantly in coming years.

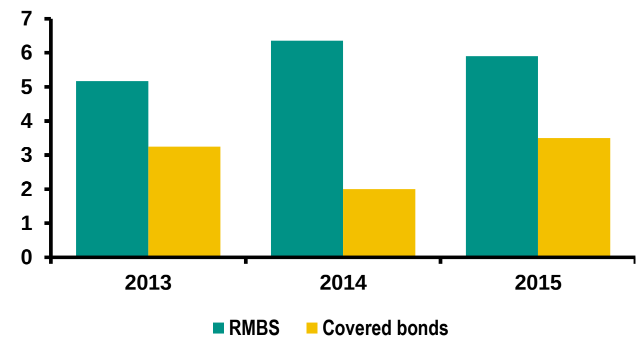
Conditional pass-through vs RMBS or full pass-through

Dutch banks and insurers finance part of their mortgage lending through the issuance of RMBS or covered bonds. These, in turn, are backed by Dutch residential mortgages. In recent years, banks and insurers have publicly issued some EUR 8bn to 9bn of covered bonds and RMBS annually, with RMBS covering the largest part.

Looking forward, it could be that the funding mix between RMBS and covered bonds will move more in favour of covered bonds, as the latter benefit from more favourable regulatory treatment. Meanwhile, covered bonds trade at tighter spread levels than RMBS, which make them a cheaper source of funding than RMBS, especially when taking into account that credit enhancements in RMBS transactions are rising. Finally, a covered bond programme provides issuers with some more flexibility to come to the market (i.e. make use of windows of opportunities), as it takes a few months to complete a RMBS transactions during which market conditions can change.

Public issuance of Dutch RMBS and covered bonds

EUR bn



Source: Concept ABS, Bloomberg, ABN AMRO

The invention of the conditional pass-through covered bond structure is in particular a threat to RMBS. This structure was invented by NIBC Bank in 2013 and led to a further narrowing of the difference in credit enhancement between both asset classes. So far, Van Lanschot and Aegon Bank have followed NIBC in establishing a conditional pass-through programme, which we expect in all cases to replace their RMBS programmes. We also think that more Dutch financial institutions will follow in coming years.

Having said that, the European Commission's aim to revive the ABS market via simple, transparent, and standard securitisations could support RMBS issuance. Furthermore, not all RMBS issuers will be able to switch to covered bonds, which will keep RMBS as an important source of funding. On top of that, RMBS issuance could receive a boost from the trend that insurers are gaining market share, as they tend to be more inclined to issue RMBS than covered bonds.

Next year, Solid Mortgages will introduce the Danish mortgage model in the Netherlands (please read a detailed note here). In the Danish model mortgages are directly funded on the capital markets, using a full pass-through covered bond structure. So, next the soft bullets and the conditional pass-through structure, a full pass-through structure will be available in the Netherlands. The covered bonds issued by Solid Mortgages will also benefit from favourable regulatory treatment, but because investors bear the prepayment risk in full, it is likely that not all traditional covered bond investors will invest in this structure. On the other hand, it could attract interest of RMBS investors, which already have some more experience with prepayment risk.

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