Lower LTVs for Dutch mortgages

- Indexed loan-to-value ratios of existing mortgage loans have declined on the back of additional repayments (~1.6%) combined with a slight increase in house prices (2.1% yoy).
- As a result, there are fewer homeowners with LTV ratios exceeding 100%.
- The LTV will continue to be pushed downwards by further tightening of lending standards. Moreover, mortgage rates are increasingly differentiated by the LTV bucket, making low LTV mortgage loans relatively more attractive for borrowers.
- In May 2015, the Dutch Financial Stability Committee will publish the findings of research on the possible impact on the housing market if the LTV limit drops below, say, 90%.

Introduction

Loan-to-value (LTV) ratios of Dutch mortgages are relatively high when compared to other countries. This fact can be mainly explained by the tax advantages on mortgage debt. Financial deregulation and mortgage product structuring around the tax deductibility of mortgage interest payments resulted in the introduction of savings and interest-only mortgages in the 1990s, enabling house buyers to take out a larger mortgage without incurring higher net mortgage costs. Because prices rose steadily from the mid-1980s until early 2008, driven by declining interest rates and rising household incomes, a market arose in which mortgage lenders chiefly applied the LTI (loan-to-income) as the key underwriting standard, and to a lesser extent the LTV. For example, in the 1990s, it was possible to get a mortgage with an LTV of around 120%. Although maximum LTVs have been lower in the last decade, the bottom-line is that the LTV of most Dutch mortgages are already high at origination date.

Moreover, because house prices have decreased in recent years, indexed LTVs have generally increased further. In fact, approximately 26% of all borrowers are in negative equity, i.e. they have indexed LTV ratios in excess of 100%. In a financial world and real economy that continues to be subject to further deleveraging, there increasingly appears to be less appetite for high-LTV mortgages. Policy makers in the Netherlands have already started to drive LTVs down. The maximum LTV is currently capped in underwriting legislation at 103%, but will decrease further, by 1% per annum, to 100% by 2018. Further legal decreases in the maximum LTV ratio cannot be ruled out.

Although the LTV cap mainly affects first-time buyers, we argue in this research note, that LTVs of existing mortgages are also poised to decrease further. First, we explain the different definitions of LTV, after which we make an analysis for future LTVs on the back of expected principal payment behaviour and house price developments. Finally, we have a look at possible future government policies to drive LTVs on Dutch mortgages lower.

Defining and calculating average LTVs

We use two definitions for LTV, the (loan) weighted-average LTV and the unweighted-average LTV. Both measures are top-down LTVs and use the current value of the mortgage loan and the current/indexed market value of the underlying property. The weighted LTV is the standard for measuring the quality of a mortgage portfolio and is calculated as the weighted average of the LTV ratios per borrower, where the weights are equal to the outstanding mortgage sum. In our case, the weighted average LTV indicates the percentage at which the value of the Dutch privately owned housing stock is mortgaged, with the exception of homes without a mortgage (14%). The unweighted LTV gives the average of the distribution of the individual ratios. This distribution is mainly suited to indicating how many homeowners have an LTV in excess of 100%.

We estimate that the weighted LTV has fallen from 91% on 1 January 2014 to 88% on 1 January 2015. The unweighted LTV – which gives the average LTV ratio per household – fell from 71% to 67%. This was due to curtailments, mortgage conversions and an increase in the amount of capital in mortgage-linked redemption vehicles, such as bank savings. In the Netherlands, the loan-to-value LTV calculation typically takes account of these pledged assets[1].

Lower LTV follows price rise and curtailments

Since mid 2013, the Dutch housing market has started to recover. The last annual price decline was registered in Q1 2014, after which house prices have slightly increased. For this year, we forecast that house prices will rise in the region of 1% to 3%. The main factors underpinning this forecast are further economic recovery (GDP growth forecast for 2015 of 1.7%), a higher degree of consumer confidence, declining mortgage rates and the upward pressure on prices caused by shrinking availability of houses for sale (see figure on next page). Moreover, both employment and disposable household income are on the rise.

[1] To our knowledge, the most recent estimate of the aggregate value of the capital in those pledged accounts, calculated by the Dutch Central Bank (DNB), dates from early 2012. At that time, DNB estimated these assets at EUR 30-45 bn, or 5% to 7% of outstanding mortgage debt.

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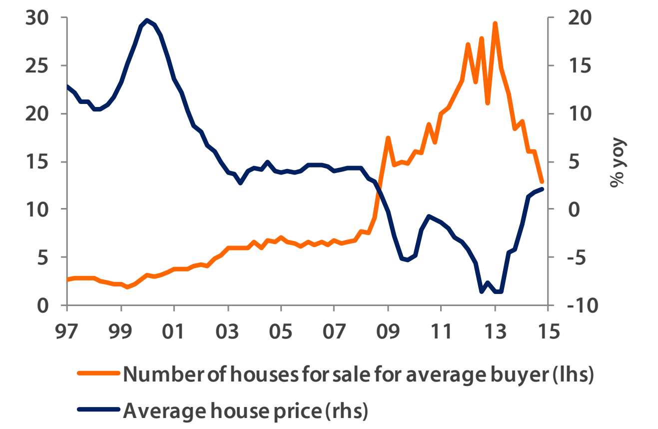
Figure 1: Scarcity and house prices



Sources: NVM, CBS, Rabobank

Another factor impacting LTVs is the hike in mortgage prepayments in 2014. We estimate that in 2014 alone an additional EUR 10 bn was prepaid, mostly in curtailments (partial prepayments), amounting to some 1.6% of total gross mortgage debt.

The considerable scale of these curtailments is largely the result of government policy. From 1 October 2013 to 31 December 2014, the tax-free limit on gifts was raised substantially, with a view to stimulating the property market. During that period, tax-free gifts amounting to a maximum of EUR 100,000 were permitted, irrespective of the relationship between donor and recipient and regardless of age. The only condition was that recipients had to use the money towards paying for their own home. This measure expired on 1 January 2015. Currently, the maximum one-off exempted gift is some EUR 52,752 from parents per child up to the age of forty, towards home ownership or educational costs.

Also the tax on wealth (equalling 1.2% on wealth above EUR 20k) in combination with the low-rates environment makes reductions in mortgage debt also attractive from a tax-efficiency point of view. For this reason, we also recorded relatively large-scale mortgage curtailments in 2013. The combination of gradually rising prices, additional principal repayments and the above statutory measures have led to declining LTV ratios and a smaller proportion of home-owners with LTV ratios exceeding 100%.

The EUR 10 bn worth of additional mortgage repayments made during 2014 had a specific effect on the weighted average LTV. It was mainly homeowners with lower LTVs who made the additional repayments; we estimate that EUR 8 bn worth was repaid by borrowers with LTVs already below 100% LTV. Consequently, the higher outstanding mortgages have been weighted relatively higher. While the weighted average LTV has declined, it could have fallen more rapidly if more money had been released to the younger generation, which was in fact the idea behind the expansion of the tax exemption on gifts.

Fewer homeowners under water

According to our calculations, the percentage of homeowners with negative home equity has dropped from 29% (Q1 2014) to 26% (Q1 2015). Assuming a scenario of an average annual house price increase of 2% and a small percentage of more curtailments on interest-only mortgages (1% per annum), the number of homeowners being under water is likely to fall to 11% in 2020 and 4% in 2025. Our calculations refer only to current homeowners and do not take into account the higher LTV ratios of first-time buyers. If we were to include this group in our calculations, then the percentage of negative-equity borrowers would decline more rapidly, as the vast majority of first time buyers would already have an LTV below 100% after one year.

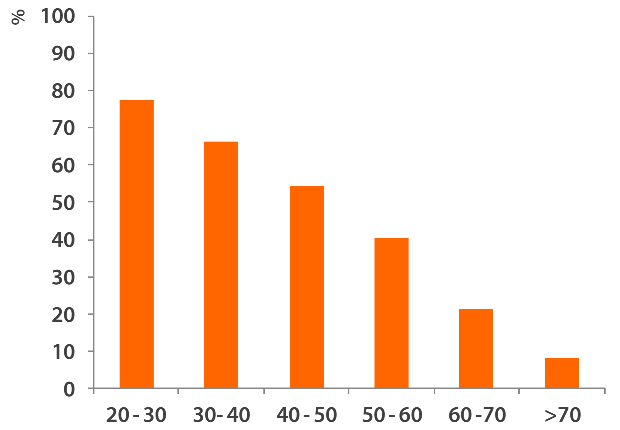
Table 1 - Mortgage borrowers with LTV > 100%*

	2014	2015	2020	2025
Age of borrower (in 2014)				
17-24 years	68%	63%	31%	8%
25-34 years	70%	62%	26%	7%
35-44 years	38%	33%	12%	5%
45-54 years	18%	16%	7%	3%
55-64 years	10%	9%	4%	2%
65-74 years	7%	7%	4%	2%
75 year and older	8%	8%	6%	4%
Total	29%	26%	11%	4%
Purchase date				
Before 1990	4%	4%	2%	2%
1990-1995	4%	3%	2%	1%
1995-2000	12%	10%	5%	3%
2000-2008	46%	40%	15%	5%
2008 and later	60%	55%	24%	8%
Total	29%	26%	11%	4%
NHG				
Yes	37%	32%	13%	4%
No	25%	22%	9%	4%
Total	29%	26%	11%	4%

Sources: WoON2012, Rabobank
*Current mortgage stock only. Scenario 2% yearly price increase, 1% additional prepayments

The table shows that this year, 26% of current homeowners are in negative equity. In our scenario, this would drop to only 4% in ten years time. However, there are differences according to different categories. Those confronted with more-than-average negative equity are households where the members are aged under 45, those who purchased their home after 2000 and homeowners with a NHG mortgage. That said, although the group of younger households are struggling with a higher percentage of negative equity, they also have a higher repayment share in their mortgage than other age groups. This means that they will also reduce their LTV more quickly over time.

Figure 2: Share of loan parts with repayment of principal (2013)



Source: DNB

More policy measures?

In recent years, there has been a debate in the Netherlands as to whether it would be appropriate to lower the LTV after 2018, say to 90%. The potential effects of a further reduction of the LTV limit from 2018 on financial stability and on the economy are currently being studied by the Dutch Financial Stability Committee (FSC). This commission is expected to publish its findings in May 2015.

Most stakeholders in the Dutch housing and mortgage market are opposing a further reduction in the legal LTV cap, as they fear that this would dampen demand for home ownership. It is argued that legal measures are already in place to reduce the LTV both at issuance and during the mortgage period. One of these is the obligation (in order to qualify for tax deductibility) to redeem each new mortgage fully within 30 years. Furthermore, originators are already using LTV-based mortgage rates, making reduction in LTVs relatively more attractive for borrowers. As described above, the average LTV is already below 90%, and even lower LTVs are likely in the future, in particular when house prices rise further. Note that a large share of first-time buyers is still likely to opt for LTVs close to 100%, but mandatory full annuity structures (for tax reasons), as well as expected house price appreciation, result also in lower LTVs for this group over time.

Nevertheless, we cannot rule out that further measures may be taken to implement a lower legal LTV limit. From a prudential perspective, there is wish a to make households less vulnerable to negative equity situations, while there is also an increasing focus on preventing asset price bubbles on the back of ultra-low policy rates of the ECB.

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