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No Pain, No Gain: How The Housing Market Correction Is Affecting Dutch Banks

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Table Of Contents

House Prices Continue On A Downward Spiral

Risks In The Dutch Mortgage Market: Gross Leverage Does Matter

Continued Downturn Could Hurt Banks, Although The Fallout Should Be Manageable

Market Reforms Could Bring Longer-Term Gains

The Market Will Likely Find Equilibrium Via Gradual Reforms

Related Criteria And Research

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Overview

- We expect Dutch house prices to continue falling steadily in the next 12-18 months, as a result of the difficult economic environment and structural reforms aimed at gradually phasing out mortgage tax relief.
- The cost of risk on domestic mortgages (impairment charges to total mortgages loans) could increase substantially under an adverse stress scenario, albeit from a very low base; our base-case projection is a more moderate deterioration to about 12 basis points (bps) from an estimated 7 bps in 2011.
- The possible indirect effects from a housing slump could be more significant, in our view. In an adverse scenario, other sectors of the economy could generate more material losses, which could lead us to revise our economic risk assessment for The Netherlands.
- Various structural reforms of the housing market have been proposed that could support the overall stability of the Dutch banking system. However, if the final timing and shape of these differ from initial proposals, we could revise our expectations for house price development.

The Dutch housing market faces ongoing turbulent times, characterized by decreasing house prices and small numbers of house sales. At the moment, we see few signs of this abating, particularly given the difficult economic conditions domestically and in the wider eurozone, and the impending housing market reforms that the government proposed in April 2012, along with other measures to curb the budget deficit. However, we expect the ultimate impact of a further deterioration to be manageable for the Dutch banking system.

Some of the proposed reforms, most notably the changes to tax relief on mortgages and a phasing out of interest-only mortgages, could, in Standard & Poor's Ratings Services' view, contribute to further market deterioration in the medium term. However, in the longer term, we consider that other measures--such as cutting transaction tax and liberalizing the rental market--could have a more positive impact. Over time, we think these initiatives will likely contribute to a gradual normalization of the mortgage market and benefit the creditworthiness of Dutch borrowers, which in turn should help stabilize the banking system and reduce systemic risk.

Further deterioration in the Dutch housing market and an increase in unemployment could, in our view, contribute to rising loan losses on Dutch banks' large mortgage loan books, which to date have been remarkably resilient. However, we believe that banks will generally be able to contain the impact of the downturn on their earnings performance. In addition, we expect the systemwide cost of risk to be broadly in line with neighboring countries' housing markets. Despite sluggish volumes, the ongoing repricing of mortgages should, to some extent, soften the impact on banks' net profit. In our view, the indirect or "second order" effects of a prolonged housing market downturn on other sectors of the economy could pose a bigger risk to the credit exposure of Dutch banks.

Features Of The Dutch Housing Market

Dutch mortgage debt of about €640 billion at end-2011 represented 106% of GDP, the highest among eurozone countries. Loan-to-value (LTV) ratios also compare unfavorably with eurozone peers.

The high leverage of Dutch households, in our view, is largely attributable to the tax deductibility of mortgage interest payments. This feature of the Dutch market encourages borrowers to maintain high outstanding balances to maximize their tax deduction. To offset the typically higher risk of interest-only mortgages, lenders have traditionally required principal repayments into savings or investment accounts.

Consequently, while Dutch households have the highest gross leverage in the eurozone, their financial assets are also among the highest in the region. In the third quarter of 2011, the Dutch households' ratio of net financial assets to income was 1,374%--close to double the eurozone average of 767%.

Dutch mortgages typically have a maturity of 30 years, and fixed interest rates for five to 10 years. This bias toward relatively long-term, fixed-rate mortgages in our view reduces the risk of repayment shock to borrowers in a rising interest rate environment.

Prime, owner-occupied mortgages account for the vast majority of mortgages, with limited availability of nonstandard products, even when house prices were rising. This is partly due to the very tight regulation of the Dutch housing rental market (which is largely controlled by housing associations) and the implementation of the Code of Conduct for Mortgage Financing in 2007 (revised in 2011). Under the code, affordability testing represents a key element of banks' lending criteria.

A growing proportion of Dutch mortgages benefits from the Nationale Hypotheek Guarantie (NHG), which we view as equivalent to a guarantee from the Dutch state. Borrowers pay a fee for the guarantee, eligible for properties up to €350,000, which enables them to benefit from a lower interest rate from mortgage providers.

The Dutch legal framework is supportive of mortgage lending asset quality. In particular, in the event of default, mortgage lenders have full recourse to a borrower's other savings and can also apply to have access to part of a borrower's income streams.

House Prices Continue On A Downward Spiral

We observe that the Dutch economy entered a second phase of recession in the second half of 2011, and we forecast a 1% contraction in 2012, before a sluggish recovery in 2013 (see "Economic Outlook For The Netherlands: The Housing Market Slump," published May 21, 2012).

Dutch property prices have dropped about 12% since their mid-2008 peak. In nominal terms, house prices are back to 2005 levels, and we expect this correction to continue in the next 12-18 months. Our base case is that prices will decrease by a further 10% by year-end 2013, before a gradual stabilization. However, the extent of further decline will depend on the final reforms being enacted and to what extent the macroeconomic environment stabilizes.

Despite material pent-up demand, we don't expect a pick-up in market activity until the general economic environment shows signs of improvement--unlikely in 2012. Apart from our forecast 1% GDP contraction, we also expect an increase in unemployment from a 4.4% average in 2011 to above 5% in 2012 (source: Eurostat). We don't expect to see market stabilization until late 2013. We also expect the proposed measures to limit the tax-deductibility

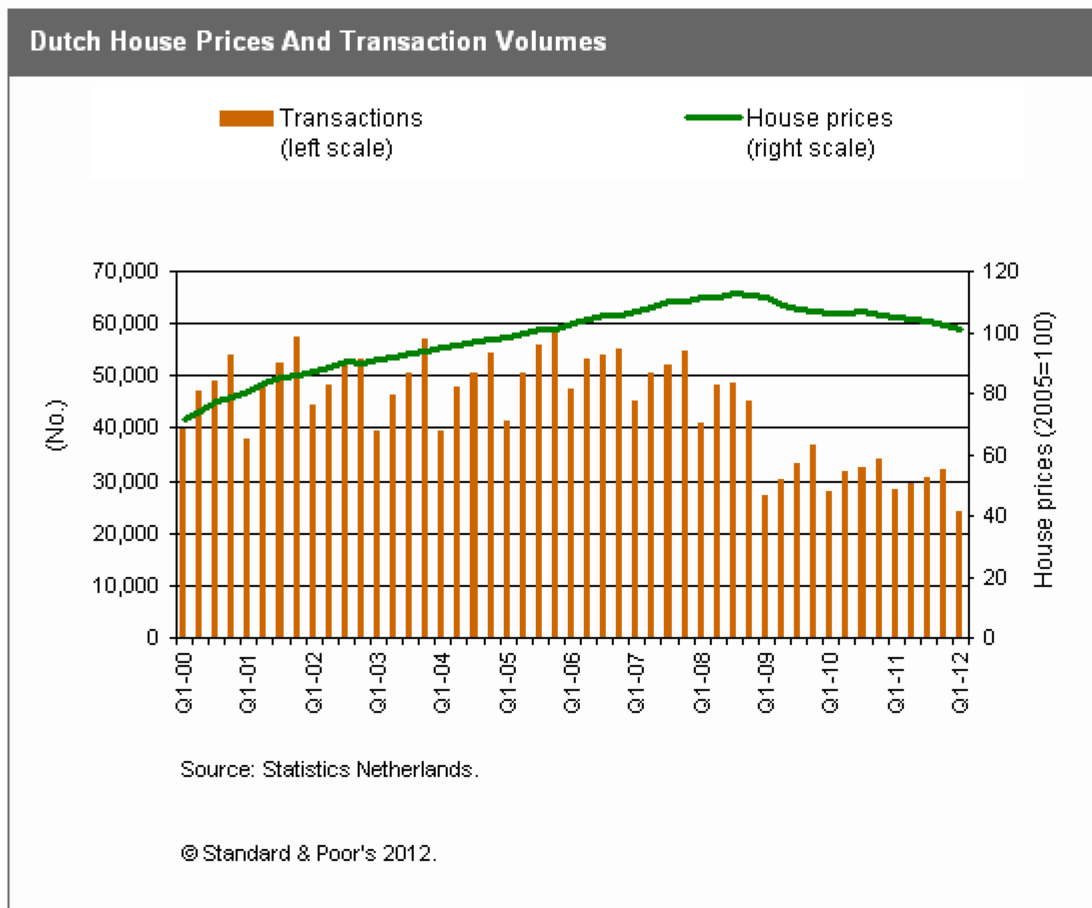
of certain mortgage products will continue to dampen the market.

However, we believe that a number of factors will limit downside risk to house prices. First, while house prices appreciated rapidly in the 1990s, growth between 2000 and 2008 was slower than in a number of European markets. The compound annual growth rate in notional house prices was around 5.7% between early 2000 and end-2008. Second, unlike in Spain and Ireland, The Netherlands didn't experience a construction boom. In fact, it faces a housing shortage.

Third, the Dutch housing market is subject to tighter regulation than other European markets. Quasi-public institutions, such as housing corporations, essentially own the rental market. As a result, tenants benefit from ceilings on rents and rental increases, and other subsidies. Strong regulation in the rental market has led to market rigidities. We believe that some of the announced reforms could reduce such rigidities, by leading over time to some increases in rental prices, for instance. This could, in turn, rebalance the price-to-rent ratio in the Dutch housing market and encourage more tenants to become homeowners.

Finally, the government has announced a number of initiatives to boost market activity, for example, the permanent reduction in the transaction tax to 2% from 6%. In addition, we believe that the authorities are trying to avoid any measures that could further destabilize the housing market. We consider that, until recently, relatively high fees on house purchases have helped reduce speculative activity in the Dutch housing market.

Chart 1



Risks In The Dutch Mortgage Market: Gross Leverage Does Matter

Over the past 10 years, Dutch mortgages have continued to demonstrate asset quality that is among the highest in Europe, despite the continued increase in households' indebtedness and the decrease in house prices since mid-2008. This is due to several characteristics of the Dutch market (see "Features Of The Dutch Housing Market" above), although in our view we cannot overlook the risks that arise from high household gross leverage.

In particular, we believe that:

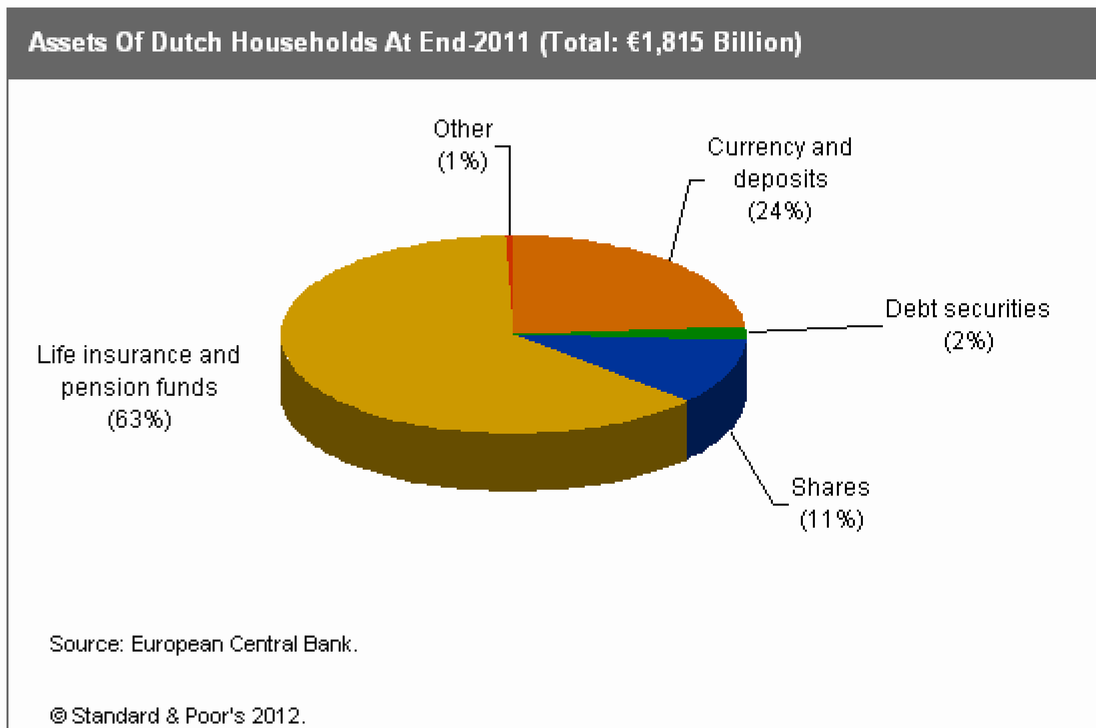
Households have high exposure to negative equity

According to the Dutch central bank (DNB), up to 500,000 households (or 12.5% of total residential mortgages) were in negative equity in mid-2011, meaning the value of the mortgage was higher than the value of the property. As long as borrowers are able to meet the required mortgage payment, this does not necessarily increase the credit risk of these loans. However, risks could arise in the event of a marked increase in unemployment, and when life events such as death or divorce occur.

Substantial household assets do not eliminate risks

We observe that Dutch households' leverage, net of financial assets, compares more favorably with other European markets. At end-2011, liquid assets in the form of cash and securities slightly exceeded total mortgage debt. However, we do not believe that these financial assets completely mitigate the risks arising from high gross leverage. First, financial assets are unevenly distributed among Dutch households. Also, although Dutch households' total financial assets are among the largest in Europe, bank deposits only represent a small share of these (24% at end-2011; see chart 2), and the majority of assets are typically less liquid, such as pension funds or life insurance policies. Furthermore, we believe that such assets expose Dutch households to a degree of market risk.

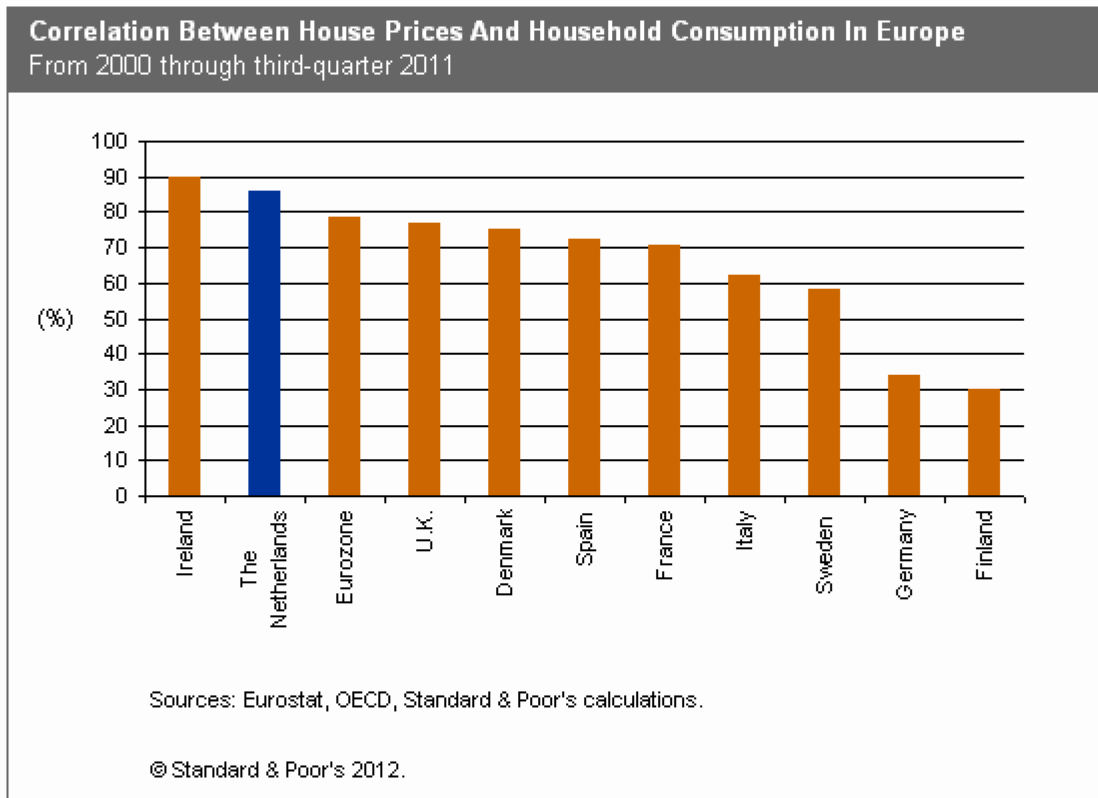
Chart 2



High leverage raises sensitivity to house prices

We consider that the high degree of leverage makes the Dutch economy more sensitive to house price fluctuations. We see this, for example, in the high correlation between house prices and household consumption since 2000 in The Netherlands (see chart 3; for more information, see "Economic Outlook For The Netherlands: The Housing Market Slump Is Dampening Consumer Demand").

Chart 3



With household borrowing vastly exceeding deposits, banks are exposed to a funding gap

For the banking sector, the very large amount of mortgage lending, combined with the propensity of Dutch households to save in pension or life insurance products rather than bank deposits, exposes lending institutions to a wide funding gap. We estimate this funding gap to be approximately €300 billion. A large part of this is covered through the issuance of residential mortgage-backed securities (RMBS), which traditionally fund about one-third of Dutch mortgages. However, the depth of the domestic capital markets, supported by the size of the insurance and pension sectors somewhat mitigate the risk caused by the funding gap. While the Dutch RMBS market has remained resilient during the downturn of the past four years, risks could arise in the event of a material adverse shift in investor sentiment toward such instruments.

Tax Relief On Mortgage Interest Payments

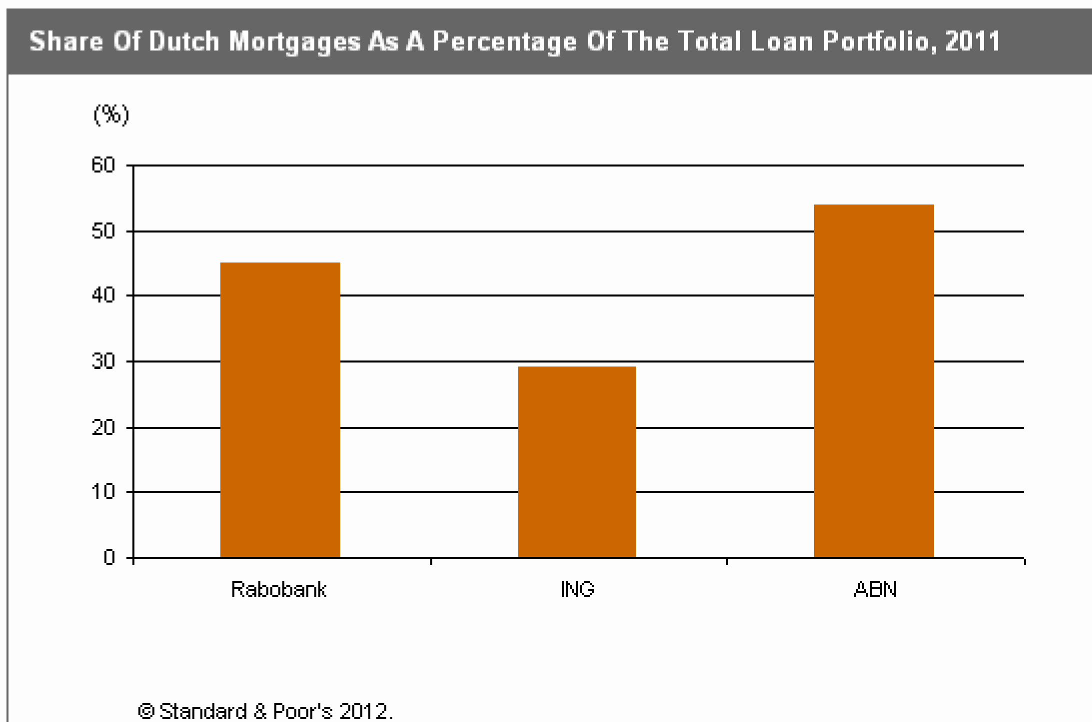
Tax relief on the mortgage interest payments of a borrower's primary residence was introduced in the early 20th century to increase home ownership rates in The Netherlands. The policy is based on the principle that costs incurred to generate income should be exempt from income tax. The primary residence is viewed as income in kind and the benefit the owner derives from the house translates into rental value of the house. In practice, the mortgage interest on the outstanding amount of the loan for the primary residence can be fully deducted from taxable income for 30 years and the rental value of the house is added to taxable income. Typically, the mortgage interest deduction exceeds the amount of imputed rent.

A number of proposed structural reforms were announced as part of the April 2012 budget agreement, including changes to the tax deductibility of mortgage interest. However, the details and implementation schedule will likely remain unclear until after the general elections in September 2012.

Continued Downturn Could Hurt Banks, Although The Fallout Should Be Manageable

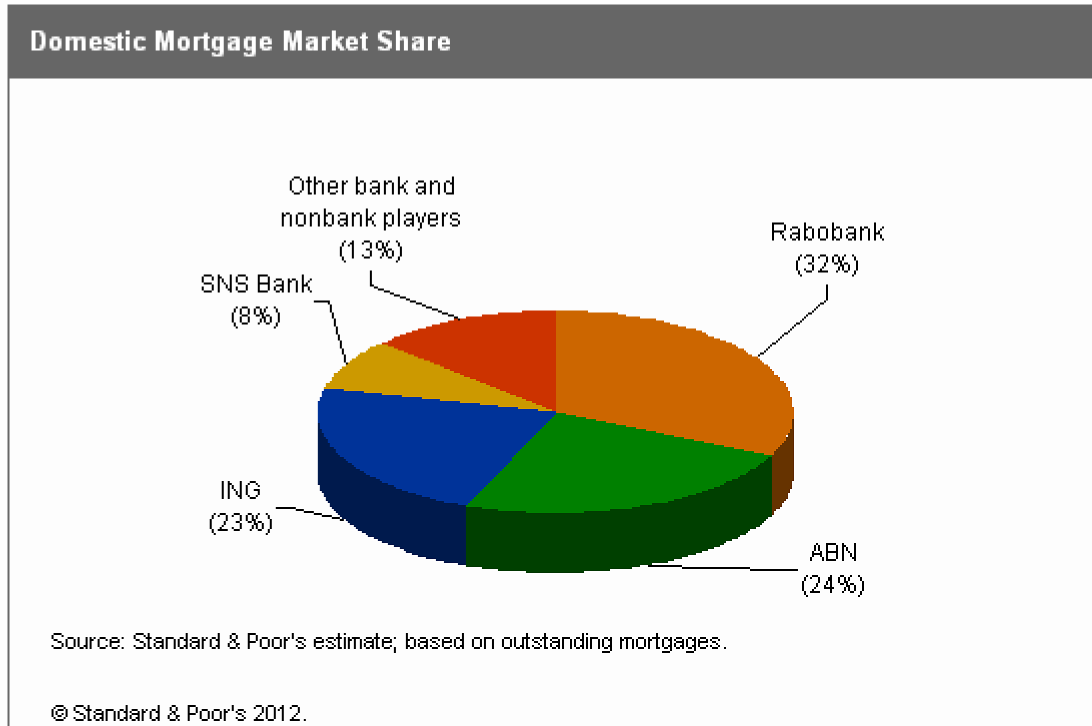
The potential impact on the banking sector of a continued housing market downturn could be material, but should be manageable, in our view. The relatively small volume of unsecured consumer lending in The Netherlands (less than €30 billion) means that risks in Dutch retail banking remain concentrated around mortgages. Domestic residential mortgages account for a large portion of the total loan portfolios of Dutch banks (see chart 4).

Chart 4



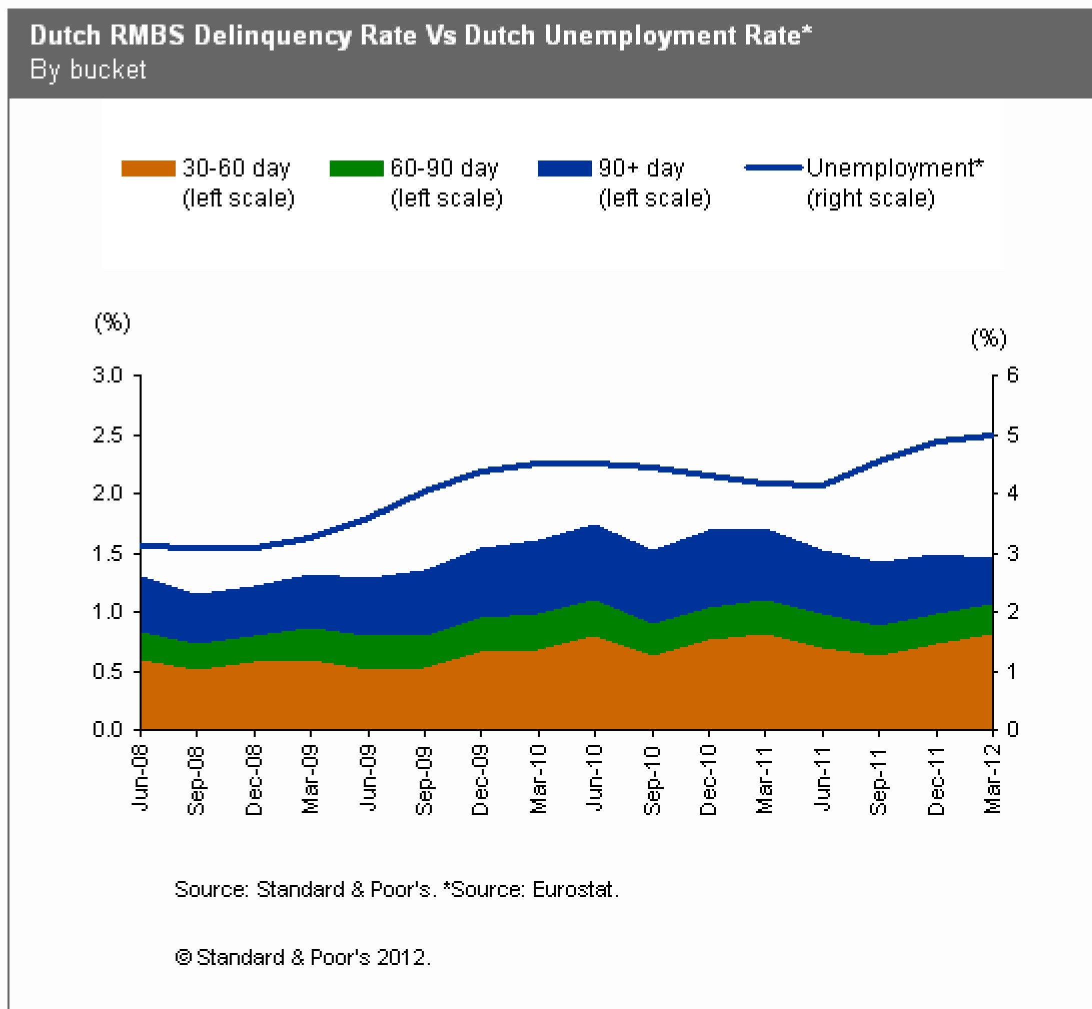
We estimate that the four largest banks comprise more than 85% of domestic mortgage balances outstanding (see chart 5). Using the top four banks as a proxy for the market, we consider that even a relatively large increase in residential mortgage-related losses will be manageable for the Dutch banking system as a whole.

Chart 5



Historically, Dutch residential mortgages have been characterized by generally sound credit quality and low loan losses. The performance of Dutch RMBS over the last decade was robust; the total delinquency rate (in terms of arrears) remained well below 2% (see chart 6). Furthermore, delinquencies on Dutch RMBS were generally uncorrelated to the unemployment rate. This is partly because of generous unemployment benefits, which amount to 75% of the daily wage for the first two months of unemployment and 70% of the daily wage thereafter (the daily amount is capped at around €190). The duration of the benefit depends on the number of years worked and is for a maximum of three years and two months. In addition to unemployment benefits, payment risk is also mitigated by underwriting standards that apply stringent affordability-based rules.

Chart 6

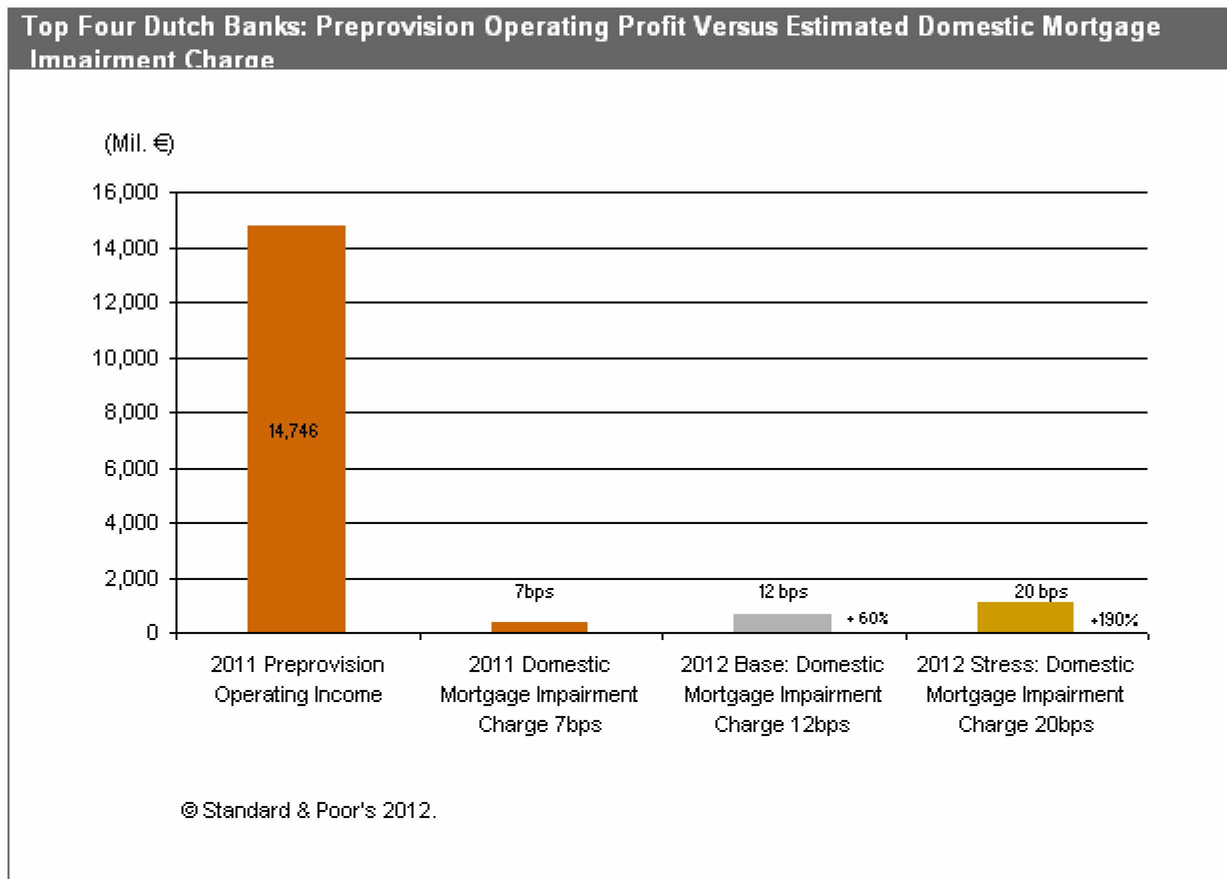


Several other factors support the credit quality of Dutch residential mortgages:

- The National Mortgage Guarantee (NHG) provided by the Stichting Waarborgsfonds Eigen Woningen (WEW). Under this scheme, borrowers pay a one-time fee of 70bps of the full mortgage amount to benefit from the guarantee. This is because banks charge them a lower interest rate. The guarantee is designed to cover any shortfall for the lender if, in the event of borrower difficulty, the proceeds from the repossession of the house do not fully cover the mortgage debt. We understand that 15%-20% of outstanding mortgages are covered by this guarantee and estimate that it covers between 30% and 40% of new mortgages granted in recent years.
- Mortgages are generally long term (30 years) and have fixed interest rates for several years.
- Limited speculative market with historically high stamp duty, and a regulated rental market.
- The revised Dutch Mortgage Lending Code of Conduct, in force since August 2011, limits interest-only financing to 50% of the market value of the house and caps LTV at 106%.
- Limited land availability and housing supply shortage.
- Lenders have full recourse to a borrower's other savings, and borrowers remain liable for any residual debt outstanding following the sale of a mortgaged property.

We consider that these factors support the credit quality of Dutch residential mortgages. Nevertheless, we consider that the combination of a prolonged housing market downturn, rising unemployment, and generally weak macroeconomic environment will result in a notable increase in mortgage-related impairment charges for Dutch mortgage lenders over the next 12-18 months. However, the pre-provision earnings of the largest banks should, in our opinion, comfortably absorb this increase (although there will be a degree of divergence between individual institutions).

Chart 7



The combined 2011 pre-provision operating profit of the four largest banks was €14.8 billion (see chart 7). The total loan impairment charge to domestic residential lending in 2011 was, on average, a very low 7bps--less than 3% of pre-impairment operating profit. Our base-case scenario is a 1% GDP contraction in 2012 and sluggish recovery in 2013, an increase by close to 1% in unemployment, and 10% total fall in house prices in 2012-2013. Under this scenario, we believe that loan impairment charges on domestic mortgage lending could increase to around 12bp. Although this would represent an increase of close to 60% in absolute credit cost, on a relative basis, the loss ratio would still compare favorably with other European markets.

We have also envisaged a material stress scenario, with a more protracted and severe deterioration in unemployment and GDP. Under such a scenario, we consider that the loan loss rate for domestic mortgages could reach or exceed 20

bps, and that unemployment could be the primary driver of loan losses in The Netherlands. Excluding any second-order effects, we still believe that the main Dutch institutions could comfortably absorb losses on domestic mortgages.

Under our Banking Industry Country Risk Assessment (BICRA) methodology (see "Banking Industry Country Risk Assessment Methodology And Assumptions," published Nov. 9, 2011), we have assessed economic risk for The Netherlands (one subcomponent of the BICRA) as '2' on a scale of 1 to 10, ranging from the lowest-risk banking systems ('1') to the highest-risk ('10'). Other countries with the same economic risk score include France, Belgium, and Sweden. Under our risk-adjusted capital (RAC) framework, normalized loss rates for prime residential mortgages in countries with an economic risk score of '2' stand at 16bps. Therefore, under our base-case scenario our expected loan losses for Dutch mortgages remain below our RAC framework normalized losses. Under a material stress scenario, these could exceed the normalized scenario, however.

We consider that the housing market slump and the difficult operating environment could have a more significant impact on other business lines such as lending to small and midsize enterprises (SME). Given the high correlation between house prices and consumption in The Netherlands (see chart 3), and because household consumption makes up over 45% of GDP, the housing market downturn could adversely affect other sectors of the economy. As a result of higher-than-expected systemwide loan losses, we could lower our assessment of economic risk for The Netherlands. Our starting point for rating banking institutions that operate primarily in The Netherlands is our 'a-' anchor, which draws on our BICRA framework. Our economic and industry risk scores for the Netherlands--both subcomponents of the BICRA--are '2' and '3', respectively. If we were to revise the economic risk score to '3', but maintain the industry risk score, we would lower the related anchor for Dutch banks to 'bbb+' from 'a-'.

Market Reforms Could Bring Longer-Term Gains

The Dutch government has gradually introduced several housing market reforms over the past few years, in a bid to reduce risks for borrowers while avoiding market destabilization. The revised Dutch Mortgage lending Code of Conduct, in force since August 2011, further tightened the framework around affordability testing, among other things. In addition, interest-only mortgages have been limited to financing only 50% of the house purchase price and the LTV ratio has been capped at 106% for new borrowers. Concomitant government measures that aim to restore market activity--such as reducing the transaction tax rate to 2% and expanding eligibility for the NHG scheme until January 2013--have had little impact given the difficult economic environment domestically and in the wider eurozone.

The government announced further reforms in May 2012, although these still need to be passed by the new parliament once elected in September 2012. The proposed measures include:

- For new mortgages, restrictions on the tax-deductibility of interest payments to loans amortizing over a maximum period of 30 years, and a gradual reduction in the LTV limit to 100% from 106%.
- A permanent reduction of the transaction tax to 2%.
- Some liberalization of the rental market, possibly leading to greater scope for repricing of rents.

The Market Will Likely Find Equilibrium Via Gradual Reforms

Various stakeholders in the Dutch housing market have proposed a range of reforms. However, it will be the new government, to be elected in September 2012, that ultimately determines which measures will be implemented and when. We think it's likely, though, that the new measures will be far-reaching. However, we also understand that there is a consensus among the stakeholders that their impact should be gradual, and that the aim of reducing household gross indebtedness should be balanced against a reduction in market rigidity. We believe that the Dutch authorities will try to avoid destabilizing the market, and will draw on past experiences of other European markets, where the rapid withdrawal of mortgage interest tax relief caused house prices to plummet.

Over the long term, though, we think that the measures likely to be adopted will be instrumental in reversing the trend of rising household indebtedness, albeit gradually. This should, in the long term, support the sustainability of the Dutch mortgage market and prove beneficial to the creditworthiness of Dutch borrowers. We also expect that the measures will slowly move toward reducing the relative funding gap for Dutch mortgage lenders. Until the market finds its equilibrium, however, we believe that asset quality will continue to deteriorate and house prices may fall further.

Related Criteria And Research

- Banking Industry Country Risk Assessment Methodology And Assumptions, Nov. 9, 2011
- Dutch Banks Are Raising Their Defenses Against The Current Tide Of Economic Uncertainty, April 4, 2012
- BICRA On The Netherlands Revised To Group '2' From Group '1', Nov. 9, 2011

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