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STUDY 2019

EMF INTEREST-ONLY LOANS STUDY

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INTRODUCTION

Generally speaking interest-only mortgage loans are not a common product among European countries. Today, the loan type has no significant penetration beyond a few Northern European countries.

Interest-only loans were common in the UK in the 1980s and 1990s, but have since been scaled back, and have no significance in new lending today. The only significant markets remaining are Denmark, the Netherlands and Sweden.

While interest-only mortgage loans are limited to a few countries the product type has taken various forms and shapes. Previously UK borrowers could apply the interest-only option to the whole loan balance for the entire duration of the loan. In this form, the interest-only option would be linked to an investment vehicle that would act as extra collateral on the loan to secure funds for paying back the entire principal when the term of the mortgage ended. The same thing is true for the Netherlands, where interest deductibility used to give borrowers a tax incentive for using the interest-only option in connection with an investment vehicle. In Denmark the interest-only option is only available for a ten year period out of the thirty year term of the mortgage. In Sweden the interest-only option is typically applied to the most secure part of the loan, for instance up to 50% loan to value.

As implied above the interest-only mortgage loan is often used in connection with a corresponding savings scheme. Indirectly this is also true in Denmark, where no direct investment vehicle is connected to the interest-only option, but where households have large private pension savings.

While still being a significant mortgage product in Denmark, the Netherlands and Sweden, interest-only loans are also being scaled back in these countries. Since the financial crisis in 2008-2009 several measures have been introduced by the banking sectors themselves itself or through macro prudential policy by authorities to limit this loan product. Hence, its significance is retreating. In 2016 the share of interest-only loans to households in Denmark fell below 50 percent. Sweden has seen the same development in recent years and in 2017 the share of households paying amortisations on their mortgage loan was close to 80 percent – up from below half in 2011.

This collation of Country Chapters on Interest-Only Loans is the result of two rounds of questionnaires among the members of the EMF Research & Data Committee, which has been drafted either by the respondents themselves or by the Secretariat in country chapters. The principal aim of this exercise is to provide an overview of the practice of Interest-Only Loans throughout Europe. Besides the country chapters provided here below the Secretariat also received replies from the Czech Republic, Germany, Italy, Spain and Romania.

Belgium

In Belgium interest-only loans are not forbidden, and present the following categories: bridging loans, bullet loans and reconstitution loans. Together they constituted in 2016 around 8% of the newly issued mortgages accounting for ca 12% of the mortgage amount. These figures changed only marginally from 2014. A pure interest-only mortgage loan with full capital amortisation at the end of the loan term is most common when speaking about interest-only loans.

Bridging loans make up for the bulk of these loans. They are used to bridge the purchase of a new home which is planned to be acquired with the proceeds of a still unsold home. In this case the lender will grant a 'bridging' loan, the capital of which will be fully reimbursed upon the sale of the old home. Though there is no rule laid down by law regarding repayment periods it is common practice to impose a limit of one year or two years. In practice, they have a maturity generally of less than 2 years. Besides bridging the transactions between an old and a new home, this loan can also be used when a person expects to receive a great amount of money (for example a heritage) or has specific guaranties (underlying investment portfolio).

The Bullet loans constitute around 3% of new mortgage or 4% of the outstanding amount. For these only the interest rate will be repaid during the term and the capital will be fully reimbursed at the end. For these types of loans the creditor generally asks for some guaranties, such as an underlying portfolio. There is no specific information regarding the average maturity length.

The final category are Reconstitution loans which account for around 1% of new loans. In this case loans are offered by insurers with a monthly payment of interest on the one hand and on the other hand premiums used for the reconstitution of the capital towards the end of the term (e.g. by means of a life insurance or group insurance). Those premiums can also be used for investment, in order to pay the capital at the end of the term. Also for these types of loans an investment or savings plan is compulsory. Reconstitution loans generally have long maturities as they are linked to life insurances or similar. A number of rules governing reconstitution loans have been laid down by law, such as "if the reconstitution term is longer than the credit term, the borrower has the right to demand from the lender that the loan be prolonged until the final reconstitution of the capital, without any kind of compensation or interest rate increase."

Denmark

Financing structure for owner-occupied homes in Denmark

To understand the attitude and practice regarding amortisations and interest-only mortgage loans in Denmark, one must first understand the financing structure of real estate in Denmark. In Denmark a loan splitting model – splitting the total financing between a mortgage loan from a mortgage bank and a mortgage loan from a commercial bank is used. Below described as the typical example for a home owner (other LTV limits apply to other types of real estate).

Unless having established a larger saving outright or for instance through the sale of another home, a Danish home owner will typically finance a home purchase with a 1st lien mortgage loan up to 80% LTV (legal limit) from a mortgage bank and another 2nd lien mortgage loan from a commercial bank covering the LTV span 80-95% LTV. A down payment of 5% LTV is required. Broadly speaking the mortgage rate on the first lien is much lower than on the 2nd lien. Therefore, borrowers normally choose not to amortise on the first lien, to bring down the more expensive 2nd lien debt faster. Actually new guidelines on lending in growth areas from the Danish FSA guide commercials banks to require amortisation on 2nd lien loan, if the 1st lien mortgage is an interest-only loan.

Attitude and practice regarding amortisations and interest-only mortgage loans

The data on Denmark and the description in this paragraph covers the 1st lien mortgage loan from a mortgage bank.

A Danish home-owner may choose a interest-only loan on the 1st lien mortgage loan up to 80% LTV as. The same requirements apply to interest-only mortgage loans and amortising loans – i.e. maximum loan length is 30 years, LTV limit is 80%. (owner occupation), etc. To obtain an interest-only loan, a home-owner will be subject to a credit valuation making the assumption that the loan is amortising. Hence, the borrower will only be approved for an interest-only loan, if the borrower is in a financial position to pay the monthly interest and amortisation on an amortising loan of the same magnitude.

Interest-only loans were first introduced by mortgage banks in 2003. The use of the interest-only option grew from 2004 till 2013 when almost 57% of mortgage loans for owner occupied homes were with the interest-only option. After 2013 the share has declined and today in late 2016 51% of mortgage loans for owner occupation are interest-only loans.

Interest-only loans must be paid back over 30 years, and deferred amortisation can only be in place for 10 out of 30 years – usually the first 10 years of the loan (hence the loan type is sometimes also referred to as deferred amortisation loans. The 10 years with deferred amortisation can however be placed flexibly throughout the life of the loan. If not all 10 years are agreed upon when the loan is issued, the borrower can opt for a year or more of deferred amortisation by notifying the lender. The flexibility typically comes at a cost as the lender will have to pay a fee everytime he/she opts for a year or more of deferred amortisation, which has not been planned before the loan was issued. Deferred amortisation payments can either be spaced out over the remaining (amortising) years of the loan or be paid in one lump sum upon loan maturity.

Ad hoc studies of the geographical distribution of interest-only loans reveal that the loan type is more commonly used in proximity to larger cities – especially in the greater Copenhagen area, while the use is more limited in rural areas.

The association of Danish Mortgage Banks has surveyed home owners use of interest-only loans. The interest-only option is most commonly used among younger (<30 years) home owners when buying a first home (or a second or third without having established a larger saving than 5%) and among pensioners (>60 years). Younger home owners most often combine the interest-only option with a fixed rate mortgage, while middle aged and older home owners more commonly combine it with an interest reset or a variable rate mortgage.

Hence, younger first time buyers' to a certain degree use the interest-only option to fix the interest rate. Another common use among younger home owners is to amortise more expensive debt faster. Amortising more expensive debt often means amortising the 2nd lien loan covering 80-95% LTV in 10 years. After 10 years amortisation on the 1st lien mortgage loan must start, however now, the homeowner has fully amortised the 2nd lien loan and has extra financial room to amortise the mortgage loan in 20 years.

Middle aged home owners are more inclined to use the saved amortisations to increase consumption – especially home owners with children – and even older home owners to increase pensions savings.

Pensioners can use deferred amortisation to balance their preferred level of net wealth and their desired consumption level. As such deferred amortisation can be seen as an alternative to home equity loans (with amortisation).

To a lesser degree, borrowers indicate that deferred amortisation proceeds are used for investments in the home – energy efficiency improvements, etc.

Latest legal limitations on Interest-only loans

In 2014 the Danish financial supervisory authority (Finanstilsynet) published the final guidelines in its "Supervisory Diamond" for mortgage banks. One guideline concerns interest-only loans. The guideline, or "point of orientation" as the Danish FSA writes, states that by 2020 regarding interest-only loans for home owners: In the LTV span above 75% of the lending limit (80% for owner occupation – in effect meaning loans with an loan-to-value of the property between 60 and 80), the share of interest-only loans must not make up more than 10% of total lending to home owners. Interest-only loans count in the numerator no matter where in the priority order the loan is placed. All loans for owner occupation count in the denominator.

On 1 January 2018 new regulation has limited highly indebted (LTI>4) households' access to risky loans. This includes interest-only loans when not used in combination with a fixed rate mortgage.

France

In France interest-only loans are neither prohibited nor there are regulatory restrictions. Interest-only mortgage loans are limited by banking practice and according to Credit Logement's estimates they account for around 1% of the home loan market. The typical product in the market is the pure interest-only loan, with full repayment of the principal at the end of the term.

In order to protect borrowers the Banque de France has set the maximal length of a loan refundable at 20 years. For these types of loans in practice the maturity ranges between 12 and 15 years. There are no strict rules regarding the repayment period which can be also modified in due course. It is possible to reduce a bullet loan length either with a total repayment or with a partial refund of the mortgage loan. However, the lender might ask for a compensation should the borrower wish to reduce the length of the loan without a partial or complete repayment. Moreover, an outstanding bullet loan can be renegotiated or refunded with an amortisable credit. Also in this case the borrower may have to ask more for the contractual penalty.

Also regarding LTV measures there are no strict rules and in principle the financing can also cover 100% of the value. In any case, banks ensure that the amount of saving or the return for significant investments during the lifetime of the loan can cover and refund the borrowed capital. Most often, the placement will be a life insurance and the bank will require collateral for its benefit.

Interest-only loans in France face ultimately a higher interest rate than an amortised loan. The payment protection insurance will be higher as well, since the risk of non-refund that the bank handles is more important.

These types of loans are fiscally attractive for rental investment and for borrowers with high level of incomes, as the French tax law allows the deduction from the rental incomes of the interest of real estate loans. As the interest is calculated on the outstanding capital that is not amortised the interest rate deduction is also more important. Therefore, the typical interest-only loan holder is an investor wishing to develop its real estate portfolio and already owns her principal residence and has a deep knowledge of the market.

Ireland

Since the start of 2013, less than 1% of new mortgage lending has been on interest-only terms, with the remainder fully amortising. Interest-only lending peaked in 2006 in volume and value terms and in 2007 as a share of activity. The main customers for interest-only loans were buy-to-let customers or customers re-mortgaging with another lender without buying property.

Research published by the Central Bank of Ireland in 2014 indicated that some 89% of the loans that originated as interest-only, were drawn down between 2005 and 2008. More than four out of five interest-only mortgages were taken out by buy-to-let customers and some 85% of has tracker rates linked to the ECB base rate. In terms of the property, almost half were located in Dublin – a higher concentration than for principal-and-interest mortgages and a quarter were used secured on mortgages, compared with one in ten for principal-and-interest mortgages.

The Netherlands

In the Netherlands mortgages may consist of several mortgage loan parts with or without regular repayment schedule. The most common types are:

Annuity mortgage: an amortising mortgage with annuity based repayment schedule.

Savings mortgage: a mortgage without contractual repayments of the principal during the term of the loan, but contractual periodical payments are made into a savings account that is pledged to the mortgage. Upon maturity, the mortgage is fully repaid out of the savings account.

Investment mortgages: comparable to a savings mortgage, except that the periodical payments are invested in stocks, and thus at maturity full repayment is uncertain.

Interest-only mortgage: a non-amortising mortgage without a savings or investment account pledged to it.

The popularity of interest-only mortgages and mortgages with a separate capital build-up originates from the wish to profit maximal from tax deductibility. Since only interest is eligible for tax deductibility. This popularity lasted until legislation changed.

2011: Change in Code of Conduct for Mortgages Loans

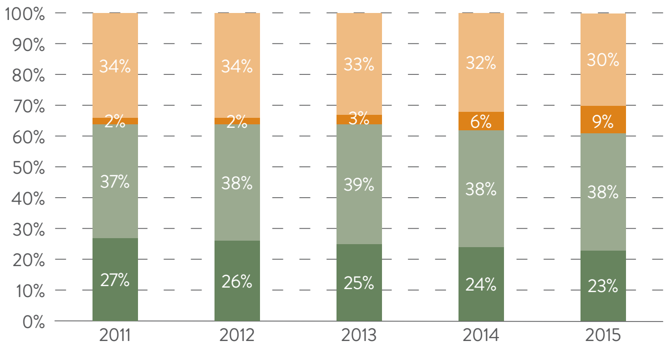
In 2011 the banks joined in the NVB (Dutch Federation of Banks) changed the Code of Conduct for Mortgages Loans. Since then the Interest-Only loan part may account for at most 50% of the new mortgages issued.

2013: Change in Tax Deductibility

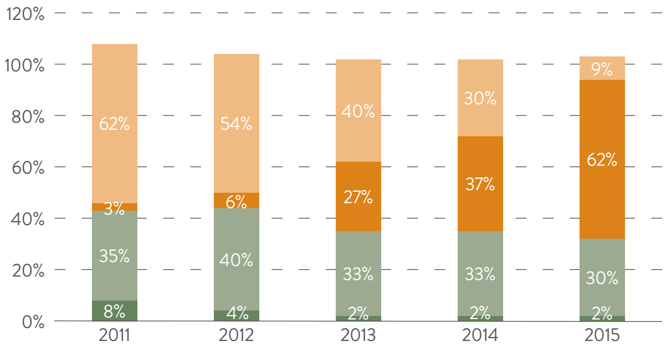
Since the start of 2013 new legislation was issued. Mortgages need to be repaid in full after 30 years and at least on an annuity basis in order to be eligible for tax deductibility. The deductibility for existing mortgage remains

GRAPH | COMPOSITION OF MORTGAGE PORTFOLIO AND MORTGAGE PRODUCTION OF THE LARGE BANKS IN THE NETHERLANDS

MORTGAGE PORTFOLIO DEVELOPMENT (LARGE BANKS)



COMPOSITION OF NEW MORTGAGES (LARGE BANKS)



■ Interest-only – 100% ■ Interest-only – partially
■ Annuity-based and straight-line ■ Savings and investment products, other

Source: Dutch Central Bank, Nov 2016

intact, but the maximum rate at which the mortgage interest rate can be deducted will decrease by 0.5 pps until reaching 38%. In January 2017 the maximum rate was 49.5%.

Furthermore is the maximum LTV stepwise reduced from 105% of the market value in 2013 to 100% in 2018. Only in case of investment in energy-saving, the maximum LTV may be 106%.

Since 2013 banks are facing severe penalties in case the Code of Conduct is breached.

Interest-only portfolio

Since the introduction of the new legislation in 2013 the production of mortgages with interest-only dropped from 44% in 2012 to 32% in 2015. Mostly originated from refinancing existing mortgages. Ultimo 2015 61% of the total Dutch mortgage debt at the four large Dutch banks comprises interest-only loan parts (source: Dutch Central Bank, Nov 2016). Coming from 64% in 2012 this share of interest-only mortgages is expected to further decline in the mortgage portfolio.

Poland

There is no explicit legal prohibition in Poland to issue Interest-only mortgages, but for the time being this type of loan is not present in the country. As such, potential new Interest-only loan issuances face the requirements for all residential mortgages, regardless of their amortisation, namely the maximum tenure of 35 years and an LTV ceiling at 80%, which can be increased up to 90% if part of the exposure exceeding 90% is ensured or if the borrower can provide additional collateral.

In any case, according to the Recommendation of the Polish Financial Supervisory Authority all mortgage loans with deferred payments should be treated with caution. Regarding loans secured by commercial real estate, banks should make a careful assessment of the possibility of repayment of the loan, including, in particular, the assessment of the financial plan of the investment. Banks should also maintain a cautious approach in the case of a loan with a custom repayment schedule, including the balloon payment schedule.

Besides, considering the characteristics of the financed transaction, the terms of repayment of credit exposure should also allow indirect control through the systematic monitoring of repayments. Particularly the bank should avoid to provide grace periods of interest payment or capital payments, excessively long period of repayment exposures arising from their low profitability or excessive concentration of exposure with a balloon repayment schedule in the loan portfolio.

Portugal

In 2016 the mortgage lending market showed a large increase in hiring, with new contracts increasing 34.2% in 2015. This increase has reinforced the growth occurred since 2013. However, despite the growth in 2016, the balance of loans portfolio decreased due the early repayment and the maturity of the loans being higher than the new hirings.

Under current legislation, housing loans are intended for the acquisition, construction and improvement of permanent, secondary or leasehold housing, as well as for the acquisition of land to the construction of owner-occupied housing.

Mortgage loans in Portugal can take three forms, with the interest-only mortagage loans option being one of them.

The Standard payment mode is the most common in Portugal where the customer amortises the loan in constant instalments of principal and interest and the principal repayment starts at the first instalment. Over the years, the capital amortization is greater and the interest rate lower.

Another mode is with principal deferred for the last instalment (between 10% and 30%) towards the end of the loan term. The benefits are constant during the term of the contract and lower than in the standard repayment modality. Deferred capital is paid in one instalment at the last payment and the total amount of interest payable will be greater than the standard refund mode.

In the lack of capital mode, the customer contracts with the credit institution an initial period where it does not amortize capital but only the payment of interest (grace period). During this period the benefit is lower than in the period after the grace period, where the reimbursement becomes a constant instalment of principal and interest (standard repayment mode). If the grace period was large, the period that the client will have for the reimbursement of the capital was shorter and the instalment deterioration was greater. In this mode, the total amount of interest payable will be higher than in the standard repayment mode.

According Bank of Portugal, "Relatório de Acompanhamento dos Mercados Bancários de Retalho_2016", in 2016 the mortgage loans hiring accompanied the decrease in the average spread of variable rate contracts indexed to Euribor at 3, 6 and 12 months, with the variable interest rate the most frequent type of rate with 83,4% of the new hiring. Nevertheless, the fixed interest rate has registered a significant increase in the number of mortgages loans concluded.

The initial average maturity of the new housing credit agreements concluded in 2016 was 32.8 years (vs. 32.1 years in 2015), higher than the contracts entered into 2015 and higher than the average term of the live contracts in the portfolio, keeping the grow trend of the average contracting verified since 2013.

Regarding variable rate, there was a decrease in the Euribor 3 month (0.9% in 2016, compared to 14.1% in 2015) and Euribor 6 months (12.3% in 2016 from 59.4% in 2015). The Euribor at 3, 6 months has remained negative levels and the Euribor 12months has changed to negative values since Feb.16.

In 2016, the average spread of mortgage loan contracts was 1.98 pp (33bp less than in 2015).

In 2016, mixed-rate contracts averaged an initial six-year and ten-month flat rate, similar to that recorded in 2015.

The average spread of mixed rate contracts was 1.11 pp in mortgage loans.

About fixed rate in the contracts signed in 2016, the average term was 25 years in the mortgage loans.

Around 15% of fixed rate contracts had a duration of five years or more.

Regarding re-negotiation of outstanding housing loans, the most frequent renegotiated financial conditions were the change in the term of the contract, change in the interest rate type and the introduction or modification of an initial grace period on principal. At the level of changes in interest rates, they were essentially to convert the variable interest rate into fixed interest rate.

Sweden

Swedish household indebtedness has risen continuously since the mid-1990s, both in absolute figures and relative to disposable income. This has coincided with a continues rise in house prices and a long-term trend towards lower interest rates. The debt ratio (the loans in relation to disposable income) for Swedish household is, on average, 180%. This level is relatively high when compared internationally. At the same time, it is important to note that young households and urban households have a debt ratio which is significantly higher than the average. For example, the debt ratio for households with new home loans in Stockholm is 534% , i.e. their loans correspond to more than five times their annual income after tax.

The attitude and practice regarding amortisations and interest-only loans have changed in Sweden during the last decades. In the 1990ies it used to be practice amortising and interest-only loans were uncommon. However, until around 2011/2012 the share of interest-only increased continuously. In 2011 a significant share of the mortgage stock was interest-only, at least below LTV ratios of 70%.

The increasing household debts and especially mortgage debts, has been heavily debated in Sweden for several years. Even if most experts find economic rationales for the housing price increase, there are worries of a too high household indebtedness. Recommendations to constrain further increases of the Swedish household debt rate have been expressed by both IMF and European Commission.

A number of measures have been taken in recent years for the purpose of counteracting high indebtedness. The Swedish Financial Supervisory Authority introduced in 2010 a mortgage cap, whereby home loans may not exceed 85% of the value of the home. The Financial Supervisory Authority has also introduced a risk weight floor for Swedish mortgages in order to tie up more capital in relation to banks' mortgage lending. The risk weight floor for mortgages is currently 25%. The Swedish Bankers' Association has also recommended that its members present individual repayment plans when granting new home loans.

Another proposal to tackle high indebtedness is the introduction of amortisation requirements. In June 2016 the Financial Supervisory Authority's first regulation on amortisation requirements entered into force. The regulation means that new mortgage loans from June 2016 with an LTV above 50% should amortise. Mortgages with an LTV above 70% must be amortised by at least two percent of the original loan amount each year. Mortgage loans with a LTV ratio between 50 and 70% must be amortised by a minimum of one percent annually. In March 2018 an additional amortisation requirement entered into force for households with high loan-to-income (LTI). The additional requirements imply that new borrowers whose LTI exceeds 450% (housing loans equal to 4,5 times gross income), must amortise at least 1% additional to prior amortisation requirements. The two amortisation requirements run in parallel and a borrower may be affected by both.

The Swedish Financial Supervisory Authority conduct an annual mortgage survey among Swedish banks and housing financing institutions. The purpose of the study is to analyse the situation on the mortgage market and the risks linked to household indebtedness.

In its study, the Financial Supervisory Authority noted that the household average debt ratio has increased the last year. However, the trend of steadily rising LTV ratios has been broken and the average household LTV for new loans has dropped slightly to 63%. Households are on average borrowing more, but borrows less in relation to the value of the house or apartment.

The survey also shows that 79% of households with new mortgage loans amortise.

UK

In previous generations interest-only loans were common in the UK, particularly in the mid-late 1980s and through the 1990s. Interest-only loans made up the majority of loans for house purchases from 1983 through to 1999. At the peak, they made up 83% of all loans for house purchases.

The majority of these loans were backed by an investment vehicle, most commonly an endowment policy. These policies were designed to pay off the capital of an interest-only mortgage, when the term of the mortgage ended.

They became less popular in the early 2000s, when stock markets did not achieve growth rates that these policies required. This meant many endowment policies would fail to meet their targets, leaving investors potentially unable to fully pay off their mortgage when it became due. The other reason for the decline was that it became apparent some endowment policies had been sold inappropriately without fully advising potential downside risks, which led to mis-selling claims.

As a result, there were fewer interest-only loans taken out, and they by 2002 these for only 12% of all loans.

In the lead up to the financial crisis, interest-only loans became more popular and by 2007, around one third of all loans were interest-only. Of these loans, a third were taken out by first-time buyers, representing a tenth of all loans made for house purchase. Soon after the financial crisis, the number and relative proportion of interest-only loans fell sharply, driven in part by house price falls.

This trend continued, and each year the numbers of interest-only loans issued fell further. Following the introduction of the FCA's Mortgage Market Review rules in 2014, interest-only loans can now only be made if the borrower can demonstrate a credible strategy for repaying the capital. Additionally, affordability for an Interest-only loan must be assessed as if the borrower were making capital and interest basis. As of 2017, interest-only loans represent a very small proportion of new residential lending, and largely advanced only to home movers and remortgagors, whose previous loan was also on an interest-only basis. Interest-only is virtually non-existent amongst first-time buyers.

Given this absence of first-time buyers amongst interest-only lending, the median age of borrowers is 58 years – far older than repayment mortgages. The term length of interest-only loans has fallen since 2006/07, from around 22 years to 15 years in 2011. It has since increased a little and is 17 years at the moment. This, in part, reflects the fact that borrowers tend to be older, and so loan terms naturally tend to be shorter.

In 2013, the Financial Conduct Authority (financial regulator in the UK) agreed with lenders to contact borrowers who are on interest-only loans to minimise the risk that can arise from these loans when they reach maturity. This was not because non-payment risks were widespread, but because the size of the back-book (three million interest-only loans) meant that if repayment issues did arise in the future, they would potentially be large scale.

There were three peaks in the future that were being targeted:

- 2017/2018 which was the result of endowment mortgages sold in the 1990s and 2000s and were typically comprised on people reaching retirement age which high incomes and high levels of equity in their property
- 2027/2028 is the second significant peak, the result of interest-only mortgages typically lent from 2003 to 2009. This group borrowed a significant amount and have lower forecasted equity in their property
- 2032 is the final peak, driven by residential interest-only loans from 2005 to 2008, which consist largely of highly indebted borrowers with low or negative equity at the point of maturity

As a result of the action taken by lenders over the past few years, the number of interest-only loans has fallen sharply over the last few years. In 2012, the stock of interest-only loans was 3.2 million. Since then, it has fallen to 2.2 million. While some of these loans matured naturally, around two thirds came from early redemption of some sort or another.

The composition of the stock of interest-only loans has evolved significantly over the last few years. Just four years ago, there were 900,000 interest-only loans with a loan-to-value (LTV) of over 75%. In 2016 this had fallen to just over 300,000.

These trends are likely to continue, as few new interest-only mortgages are issued, and lenders actively work to reduce the number of interest-only loans on their back-book. There have been almost no recorded instances of repossessions of term-expired interest-only loans, as lenders work with borrowers to find other ways to repay these loans.

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