

Box 7

THE INFLUENCE OF MORTGAGE PRODUCT INNOVATIONS ON RISKS TO HOUSEHOLD DEBT SUSTAINABILITY

In an environment of strong competition, banks in the euro area have been offering new mortgage products targeted at a larger number of borrowers. With these new products, two previous obstacles to borrowing have been removed. First, it is now possible in some countries for households to borrow higher amounts with little or no down payment, through higher loan-to-value ratios. Second, in a number of countries, other products have become available, allowing middle and lower-income borrowers to alter repayments relative to their financial resources, while borrowing larger amounts than might have been possible in the past. This has mainly been achieved by extending the average loan maturity (up to 30-35 years in some countries). This Box reviews the specific features of these mortgage products and their implications for the sustainability of household debt.¹

In many euro area countries, banks are increasingly offering a variety of types of innovative mortgage products. First, “accordion” variable rate mortgages offer the option of keeping the monthly instalment constant, even in the case of a change in the interest burden, the adjustment being made through an extension of the loan maturity. In the euro area, such products exist in Belgium, Italy, Spain, France and Greece. Second, mortgage products are now increasingly offering a wide range of flexible repayment options (such as deferred start, payment break or reduced starting payments), allowing borrowers to match their repayments to their cash flows, which can be affected by seasonal increases in expenses (for instance, a “payment holiday” can be granted for one or two months during the summer or at the end of the year). Finally, “interest-only” or “amortisation free” mortgage loans allow the deferral of the payment of the principal for a given period or even until the end of the loan.

According to a recent study,² interest-only products are now available in most euro area countries (with the exception of Finland; no information was reported for Austria, Greece and

1 Other types of mortgage products have recently appeared, such as equity release loans, foreign currency loans and reverse mortgages. However, this Box focuses on innovations that have the greatest impact on households’ monthly repayment burden.

2 See London Economics (2005), “The Costs and Benefits of Integration of EU Mortgage Markets”, Report for the European Commission, DG Internal Market and Services, August.

Luxembourg). In the Netherlands survey results indicate that 41% of outstanding mortgages were interest-only in 2003³; they also tend to be more common among lower-income households. However, it is unlikely that interest-only mortgage loans in the Netherlands are granted to finance the total value of the property. They are rather often used in combination with another type of loan, or as a second mortgage, for instance to finance renovations. Moreover, Dutch banks tend to grant interest-only mortgages with rather conservative loan-to-value ratios. In Spain, most mortgage lenders now offer a wide range of products with more flexibility in repayment schemes. They have recently started to grant mortgages under which borrowers pay only interest for a period of one to three years. In France, loans with a deferred capital repayment are only granted in special cases (e.g. subsidised loans and student loans). Interest-only loans, whereby the repayment occurs at the end of the loan duration, are mostly granted to investors for buy-to-let purposes, to take advantage of particular fiscal schemes. They are often offered together with an investment product, allowing the lump sum for repayment to be built up.

Typically, interest-only mortgage products were originally designed for wealthier households, which tended to use them as a cash management tool – investing the cash freed up during this period at a higher return – and which were able to sell, if necessary, financial assets to pay off the loan amount. They were also suited for households with irregular income, but able to make voluntarily early principal repayments when they have more income, or for young households expecting their income to rise sharply in the near future. However, for many “ordinary” borrowers, such flexible mortgage products have now become the best financing option, allowing them to overcome the financial hurdle to home ownership brought about by the recent increase in house prices, and to adapt their repayments to the pattern of their financial resources.

However, innovative mortgage products do potentially contain certain specific risks. A longer loan duration and amortisation period entail a higher probability that the household could face debt sustainability problems, for instance caused by a period of unemployment with a lower income, or loss of income altogether. With regard to interest-only loans, they might be a good choice for buyers intending to move or refinance – and therefore repay the principal – before or at the end of the interest-only period. However, after the initial amortisation-free period, borrowers could face a sudden, sharp increase in their financial burden for which they might be unprepared. Moreover, should house prices decline, there is a higher risk that households would be left with low or even negative net housing equity, the outstanding balance of the loan exceeding the value of their houses. Finally, the total amount of interest paid will be higher over the term of the loan.

³ See P. J. A. van Els, W. A. van den End and M. C. J. van Rooij (2005), “Financial Behaviour of Dutch Households: Analysis of the DNB Household Survey 2003”, *BIS Papers No 22 – Investigating the Relationship between the Financial and Real Economy*, April.

In the euro area, quantitative information on these new mortgage products is scarce, making it difficult to assess the overall financial stability implications. However, some lessons can be drawn from recent developments in the US, where the growing popularity of interest-only mortgages has recently raised financial stability concerns.⁴ Interest-only mortgages (deferring principal payments for a period of three to ten years) are now being offered by most lenders, and represented a third of home purchase loans originated in 2004⁵, up from 5% in 2003. However, the amortisation-free period is substantially longer than in the euro area (up to half the total duration of the loan), potentially resulting in a high increase in the monthly payments at the end of this initial period (anecdotal evidence suggests that the monthly payment could jump by 50%, even in the absence of any interest rate rise).

Available products in the US also include option adjustable rate mortgages (ARMs), or flexible ARMs, allowing the borrower to choose a repayment scheme whereby payments in the initial period (five to ten years) might cover in extreme cases only a part of the interest payment, the remainder being added to the outstanding loan balance to be repaid later. There are also concerns that these higher-risk ARMs are increasingly being offered to riskier borrowers, who may face greater difficulties adjusting to the rise in their monthly payments at the end of the initial period. However, at present such products, which could potentially result in a “negative” amortisation of the loan (meaning that the outstanding balance increases over time instead of decreasing, as a result of accumulated deferred interest payments), do not appear to be available in the euro area.

From a financial stability viewpoint, while the innovative mortgage products that are becoming increasingly available in the euro area allow households to keep their monthly debt servicing burdens at reasonable levels in the short run, longer-term risks could be increasing, especially as the ability of households to make large principal repayments after a considerable period of time is largely untested. This would call for closer monitoring of how the nature of risk-sharing in mortgage lending is being altered by product innovation.

4 See Federal Reserve Board, Monetary Policy Report submitted to Congress on 20 July 2005, which states that “Recently there has been increased use of potentially riskier types of mortgages, including adjustable-rate and interest-only loans, which could pose challenges to both lenders and borrowers.”

5 According to data from the real estate information firm Loan Performance (see for instance the annual report on “The State of the Nation’s Housing 2005”, issued by the Joint Center for Housing Studies at Harvard University). These data refer to loans packaged for resale as mortgage-backed securities, and thus do not cover the entire market.