

## Interest-only mortgages under review: Increased regulatory scrutiny for Dutch banks

Interest-only (IO) mortgages have moved to the center of supervisory attention, with recent letters from the European Central Bank (ECB) and De Nederlandsche Bank (DNB) explicitly warning Dutch banks that current risk management and modelling practices for these portfolios are not sufficient across the entire loan life cycle. These communications are putting pressure on banks as they are expected to take decisive action to de-risk and reduce the volume of IO mortgage portfolios in the coming years.

[Rabobank](#) has become the first major Dutch Bank to tighten lending on IO mortgages, sharply reducing the share of a home's value that can be financed through an IO mortgage and setting a precedent the rest of the sector is watching closely.

This article explains why IO mortgages pose a risk, outlines the key challenges in credit risk management, and highlights how 4 most support banks in responding to increased supervisory scrutiny.

### Risks of IO mortgages

The main risk of IO mortgages lies in the foundation of the product as the borrower does not repay principal during the term, creating a sizeable bullet payment at maturity. The borrower may not have the means to repay or the ability to refinance when the loan expires. The end of the tax deductibility of mortgage interest after 30 years and the potential decline in income because of retirement are examples of factors that may affect the affordability of the IO mortgage and the ability to refinance or extend it. The lack of insight into the repayment strategy of the client brings great uncertainty.

The [DNB reports](#) that almost 45% of the Dutch mortgage book consists of IO mortgages with many of them maturing simultaneously around 2035-2038 and 2047-2052, forming a concentration risk that could pose a serious threat to the financial system. Therefore, the ECB and DNB urge banks to monitor clients and proactively discuss realistic repayment plans with them.

Additionally, banks are largely dependent on the property itself for repayment, while having little to no insight into the physical condition of the home over the life cycle of the loan. This introduces additional risk which is only imperfectly addressed by Automated Valuation Models (AVMs) as they do not capture maintenance quality or physical deterioration of the property.

### Why reducing IO mortgage exposure remains difficult

Reducing IO mortgage exposures continues to be challenging as policy measures largely affect only new lending. With demand for new IO mortgages currently close to zero due to higher interest rates, such measures have limited impact on overall risk levels in the short term. Historically, clients were encouraged to use the financial

leeway created by refinancing at a lower interest rate to make additional repayments towards their IO loan or to convert it into an annuity-based loan. However, the economic environment of higher interest rates that we are seeing today has removed this incentive for mortgage refinancing for most clients as they benefit from locked-in low rates. As a result, borrowers are more likely to keep their existing IO mortgage, leading to fewer voluntary prepayments and a lower conditional prepayment rate (CPR).

Moreover, the CPR of IO mortgages is structurally affected by both demographic trends and the institutional design of the Dutch pension system. The average age of IO mortgage borrowers is significantly higher than that of clients with repayment-based loans. As relocation frequency declines with age, meaning older borrowers are more reluctant to move, this contributes to persistently lower prepayment rates on IO mortgages. At the same time, given the multi-layered pension scheme and strong incentives to build pension payments, households allocate a significant share of their disposable income to illiquid pension savings. This naturally limits the ability and willingness of households to build up housing equity which sustains the demand for IO mortgages, reinforcing low prepayment behaviour.

### **Challenges that financial institutions face in credit risk management**

Financial institutions face several challenges in credit risk management of IO mortgages. The uncertainty around borrower repayment behavior complicates risk assessment especially when repayment strategies such as refinancing, selling collateral, or principal repayment are not contractually agreed upon. From a modelling perspective, the limited historical data on repayment sources and the client's financial position in combination with the relatively low number of fully matured IO mortgages hinder reliable analysis.

In addition, financial institutions are confronted with new supervisory expectations. Lenders are increasingly required to demonstrate clear repayment strategies at loan origination and ensure that any contract modifications align with the entities' forbearance framework. Over the full lifetime of the IO mortgage, the borrower must be assessed on its creditworthiness.

Meanwhile, there is a strong reliance on the collateral value which introduces additional risk. Uncertainty on the maintenance state of the collateral value and the use of AVMs requires a robust collateral management process including timely physical revaluations. Meeting these expectations adds operational complexity and places pressure on governance and data systems.

### **Our observations and how 4most supports banks on IO mortgages**

At 4most, we are currently supporting banks in their IO programs through updates to the Definition of Default (DoD), improved data management and credit acceptance and monitoring policies in line with supervisory expectations. During multiple projects we

have observed that the ECB increasingly expects banks to place greater emphasis on documenting the repayment vehicles for IO mortgages, particularly in the final five years of the loan term. Where repayment vehicles remain unclear or insufficiently substantiated, and client outreach does not result in adequate clarification, banks are expected to reflect this uncertainty in the client's risk classification, which may imply a higher credit risk.

Furthermore, when restructuring the payment plan due to financial difficulties or extending the maturity date, banks should assess whether such changes constitute a forbearance measure under the applicable regulatory definitions and treat the client accordingly. We also have experience at banks in the UK that faced similar scrutiny on IO mortgages and supplement our local knowledge with global insights.

Finally, the supervisory demands and changes in lending criteria will have further downstream impact and are also a key factor to consider in IRB and IFRS 9 models. We observe that segmentation is a key topic and models will have to be (re-)calibrated to accommodate this new reality and effectively manage risk.

**Need more guidance?**

Get in touch if you want to learn more about how we can assist in handling the risks associated with IO mortgage portfolios.