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Mortgage rates are rising: Should we be concerned?

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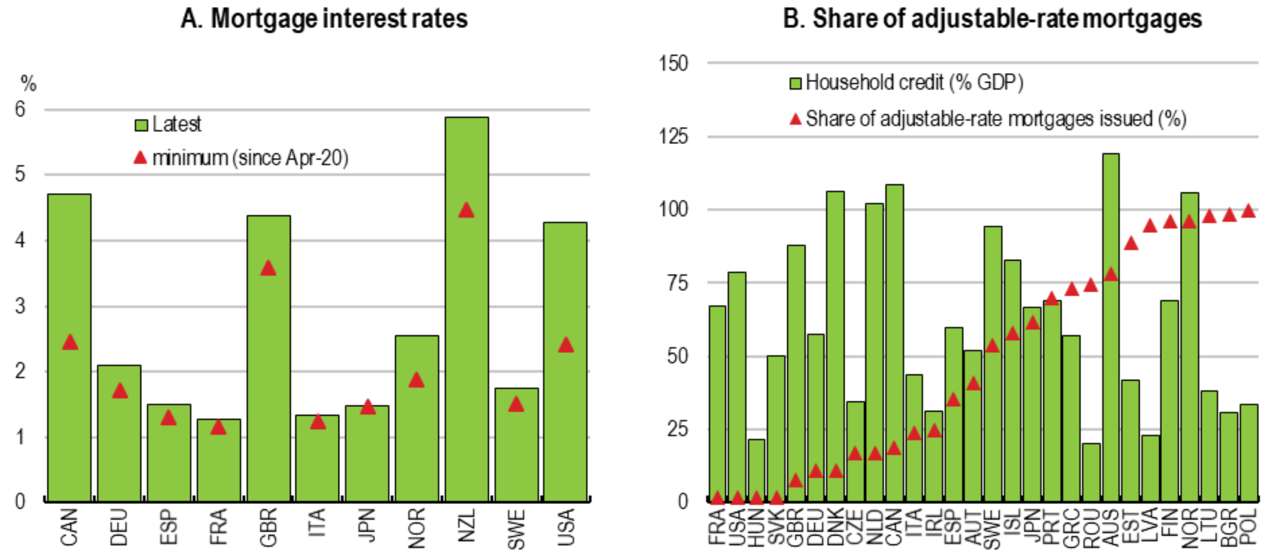
Mortgage interest rates are now rising in many OECD countries, reflecting the ongoing tightening of monetary policy by most central banks. This raises important questions about the impact on household finances and house prices, and the implications for financial stability. The latest OECD Economic Outlook (OECD, 2022) discusses these issues. Overall, financial stress among households should be contained in most OECD countries due to relatively strong balance sheets and the moderate use of adjustable-rate mortgages (ARM). However, pockets of risk do exist, and the outlook for house prices remains very uncertain. Many macroprudential authorities have already taken steps to limit over-indebtedness and reinforce banks' capital buffers, but further preventive steps may be warranted. At the same time, structural reforms in housing markets are called for in most countries, often to increase supply responsiveness.

Mortgage rates are climbing, but fixed-rate loans dominate the mortgage landscape

Mortgage rates have started to increase in several OECD economies (Figure 1, Panel A). The rise has been particularly strong in the United States, where rates rose by almost 2 percentage points in a few months. This may deter prospective homebuyers, but the impact on existing homeowners should be small in most large OECD countries. As of 2020, the median share of adjustable-rate mortgages across OECD countries was around 45%, and, except for Japan, all G7 economies had much lower shares (Figure 1, Panel B). Notably, borrowers in France, Germany, the United Kingdom and the United States rely almost entirely on fixed-rate mortgage contracts, which come with fixed payments over the life of the loan. In contrast, ARM contracts account for over 80% of the total in the Baltics and in several Nordic and Eastern European countries.

Figure 1. Mortgage rates are rising, but most homeowners are shielded by fixed-rate contracts



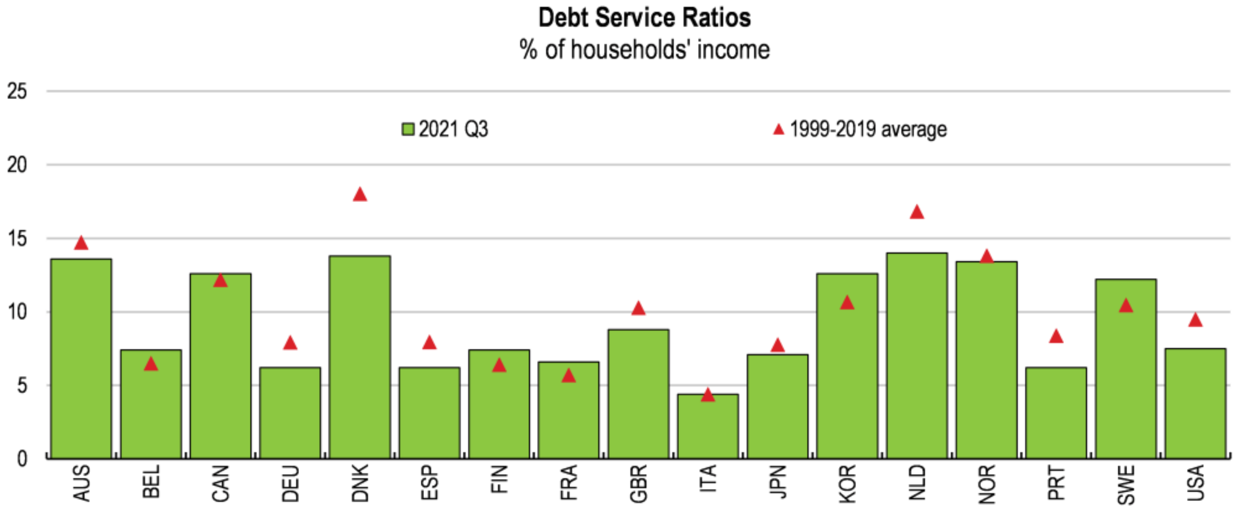
Note: Rates in Panel A based on newly issued adjustable-rate mortgages. Latest data refer to July 2022 (for Canada, Japan and the USA), June 2022 (for New Zealand, Sweden and the United Kingdom) and May 2022 (for the remaining countries). In Panel B, the level of household credit is measured as of 2021 Q3, and the average share (in value) of ARM at issuance in 2020 is used to proxy for the importance of each type of mortgage in each country.

Source: National central banks, national statistics agencies, BIS, European Mortgage Federation, and OECD calculations.

Will households be able to cope with higher debt service burdens?

Household debt, which mainly consists of mortgage loans, has grown substantially over the past decade in most OECD countries. Nonetheless, the extended period of low interest rates since the global financial crisis (GFC) has left average debt service ratios in the household sector close to or even below their long-term norms (Figure 2), suggesting that some rise in debt service burdens should be manageable for most households. Moreover, the rise in household debt during the pandemic has been matched by a significant rise in household savings, which should support the repayment capacity of many households exposed to adjustable rates. However, aggregate numbers conceal important risks that the repayment capacity of low-income borrowers could deteriorate, given the withdrawal of pandemic income support measures and higher inflation. Financially fragile borrowers in countries with independent monetary policies and rising inflation pressures are particularly exposed to the risk of a substantial rise in debt servicing costs, especially in countries where the ratio of mortgage costs to disposable income is already high for the lowest income quintile, such as Australia (van Hoenselaar *et al.*, 2021).

Figure 2. Moderate debt service ratios limit risks in housing markets



Source: BIS Credit Database; and OECD calculations.

Effective macroprudential policies are needed to limit risks from swings in house prices

House prices rose strongly and quickly in most OECD countries during the pandemic. Between the fourth quarter of 2019 and the fourth quarter of 2021, real house prices rose by 13% in the median OECD economy, leading to stretched valuations in many countries. For many reasons, the pandemic has exacerbated pre-existing tensions in real estate markets. Exceptionally accommodative monetary conditions, a surge in household savings and unprecedented fiscal support all boosted housing demand, with housing supply temporarily curtailed by mobility restrictions and logistical bottlenecks.

The future evolution of house prices is uncertain. Higher financing costs should moderate future housing demand, helping the rise in house prices to abate. However, in the short run, supply constraints could continue to sustain price increases. Although the supply of new construction slowed down only moderately during the pandemic, new housing permits and starts dropped significantly in many OECD countries. This gap, along with ongoing supply bottlenecks and labour shortages, is likely to amplify the structural housing shortages affecting many countries, helping to sustain prices.

Given the large uncertainty surrounding the outlook, it is critical that there are adequate buffers in the banking sector to ensure resilience to unexpected fluctuations in property markets. Stronger regulation in the aftermath of the GFC has limited risk-taking, helped to strengthen underwriting standards, and raised bank capital ratios. Most countries already have macroprudential policies in place to limit over-indebtedness and reinforce banks' capital buffers, but the continued build-up of housing market vulnerabilities may merit further preventive measures to limit medium-term risks, such as additional steps to lower loan-to-value or debt service-to-income ratios.

Over time, in addition to macroprudential instruments, reforms in rental regulation and property taxation may also be effective tools to address more structural housing pressures. Those tools, along with stronger public investment in social housing and potential land use reforms, especially in job-rich urban areas, could ease the tensions that are still likely to prevail in the medium and long term (OECD, 2021).

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