ASB

Economic Note

Housing Insights

29 June 2021

Can we cope with higher mortgage rates?

- We find households in aggregate have plenty of buffer to cope with higher mortgage rates. Household gearing and mortgage serviceability metrics are at low levels.
- But there are some sensitive spots, such as new entrants to the housing market. There's also a bit of re-set risk out there – 77% of all mortgage debt is on fixed-rate terms of less than a year.
- At a macro level, the RBNZ will get more bang for its buck when interest rates eventually do rise. Higher mortgage rates are also a key factor behind our view house price inflation will slow down from here.

Summary

Folk are starting to worry about the impact of likely higher mortgage rates over the next couple of years. The concern is especially pronounced in light of the economy's higher debt load post-COVID.

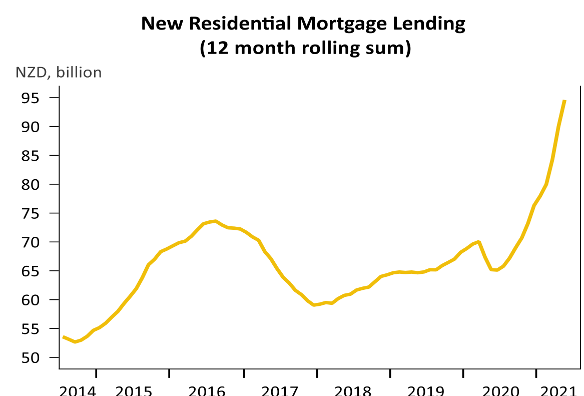
We find that households, in aggregate, have a reasonable amount of buffer to cope with higher mortgage rates. Rates would have to rise a fair way before incomes became unduly stressed. On our calculations, aggregate debt servicing costs and housing gearing levels are at the lowest levels on record.

There are some sensitivities though. New entrants to the housing market typically have less equity and a simple stress test shows debt servicing costs for these borrowers could rise above 50% of disposable income if mortgage rates really shot up. There's also a bit of re-set risk out there – 77% of all mortgage debt is on fixed-rate terms of less than a year.

At a macro level, a higher debt load will give the Reserve Bank more bang for its buck when it does come time to lift interest rates. A scenario in which mortgage rates lift around one percentage point would see an extra $3b sucked out of NZ mortgage-holder's pockets annually. Higher mortgage rates over the coming years are also a key factor behind our view house price inflation will slow down from here. A scenario in which mortgage rates rise faster than we're expecting could produce small quarterly falls in house prices.

We've detected increased concern about the impact higher interest rates might have on the economy next year. The worry is that a higher debt load in the wake of COVID means the economy is that much more sensitive to interest rate hikes by the RBNZ. Any moves to raise rates would therefore go on to upset the housing market apple-cart, producing some potentially nasty economic side-effects.

Our aim here is to road-test this hypothesis.



Source: Macrobond, ASB

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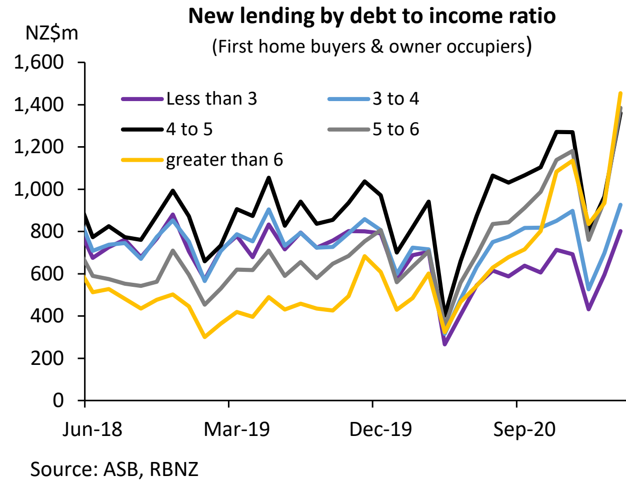
Please refer to the important disclosures at the end of this document.

A debt feast

The first point to note is that, yes, mortgage borrowing has gone nuts. Ever-higher house prices have meant that more debt has been required to either get onto the property ladder, or to trade up. New mortgage lending written over the past 12 months is thus up around 45% on the prior 12 months (chart above).

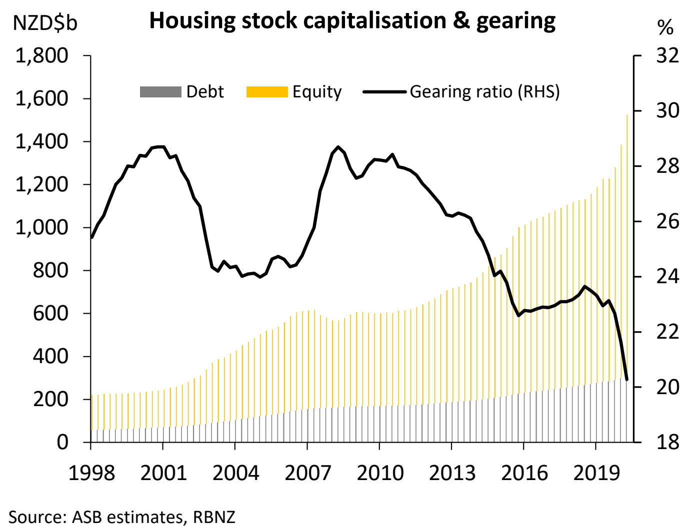


Source: ASB, RBNZ

Of course, household incomes haven't increased by anything like house prices. This means that much higher mortgage debt is being serviced by roughly the same levels of income.

Debt-to-income ratios (DTIs) have consequently jumped up. RBNZ data show that households[1] with a DTI ratio above six now account for the highest share of new mortgage lending, having been the lowest prior to COVID. New lending to households with a DTI of less than four now constitutes only a third of the total.

This is getting up there in terms of historical and international comparisons. The RBNZ has said in the past that it "keeps a particularly close watch on new mortgage lending with a DTI of over five". Offshore regulators that employ loan-to-income restrictions have generally restricted new lending to a loan-to-income ratio of five and under.[2]

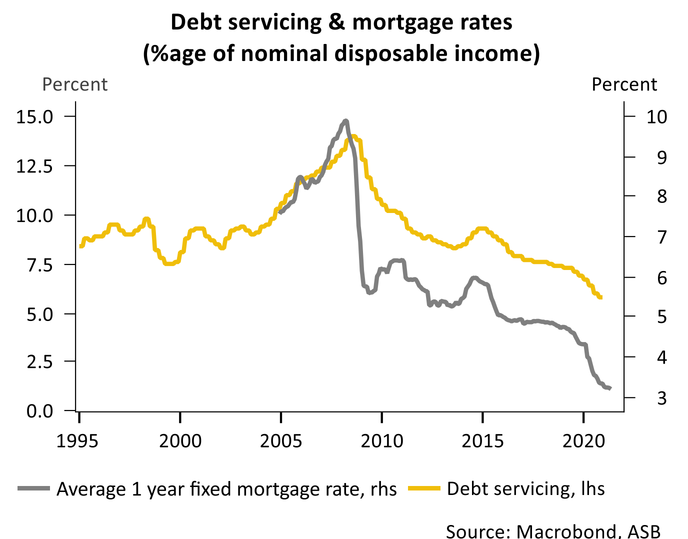


Source: ASB estimates, RBNZ

But debt servicing costs hit new lows…

So, the household debt burden has shot up. But more perspective is needed. Economists frequently wring their hands about debt without necessarily considering the other side of the balance sheet. And comparing household debt to equity shows household gearing is actually at the lowest level since records began. Our calculation of a housing gearing ratio has it at a little above 20%.

Now, clearly this reflects the fact the housing boom has (over?) inflated the value of housing assets to unprecedented levels. And there's nothing to say this value will be indefinitely sustained. Indeed, the higher house prices go the bigger the risk we see some sort of correction down the line. But the fact that households are only lightly geared, in aggregate, is still important context.

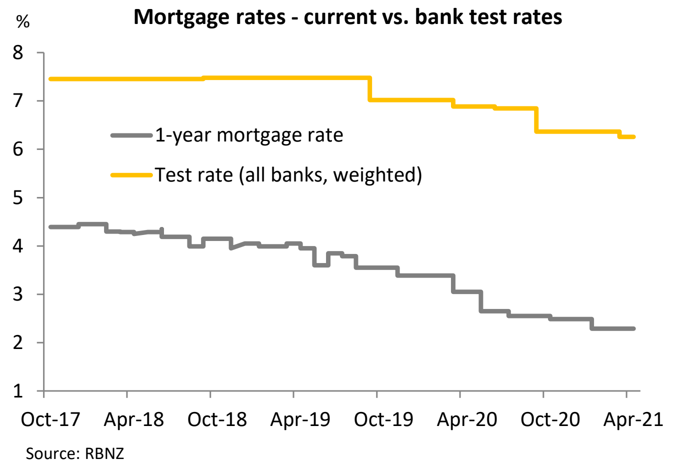


Source: Macrobond, ASB

[1] Includes first home buyers and owner-occupiers, i.e. excludes investors.

[2] Loan-to-income ratios are similar to DTIs, except that DTIs include all household debt. As a result, DTIs will usually be higher than the equivalent LTI.

The second, and more important, piece of perspective concerns the cost of servicing mortgage debt. Despite record high debt levels, the chart shows that the cost of servicing this debt is by no means excessive. In fact, it's the lowest since records began at just 6% of total disposable income.[3] Just prior to the GFC it was 14%. This reflects the aggressive falls we've seen in mortgage interest rates over the past few years.



Source: RBNZ

…suggesting households have a good buffer

The point here is that, given the very low starting point for debt servicing, households should be able to tolerate reasonable increases in mortgage rates without budgets becoming unduly stressed. Key in this regard is that unemployment remains low and modest household income growth continues. Our central economic forecast incorporates both.

Reinforcing the point is the fact that banks have not dropped mortgage serviceability test rates that much, despite much sharper falls in mortgage rates. RBNZ data show the weighted average serviceability test rate is still up around 6.3%. This compares to a one-year mortgage rate of around 2.3%.

Where are the sensitivities? – New entrants

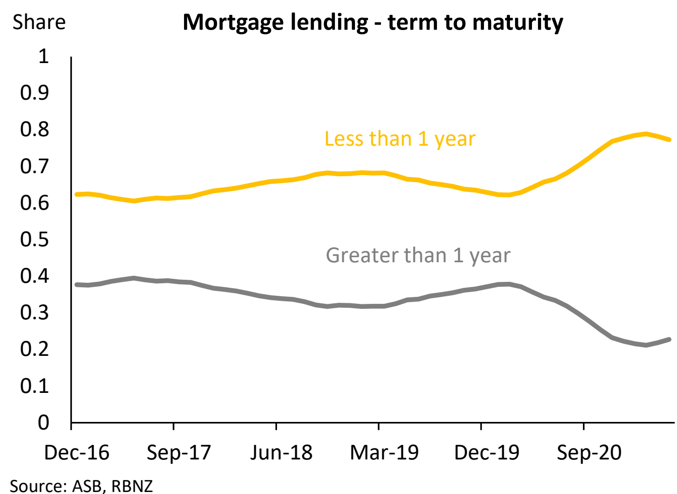
Macro-level data are all well and good but average out the extremes. There's no such thing as the 'average borrower'. Newish entrants into the housing market are more at risk from higher mortgage rates. They will typically have lower equity, and may not have budgeted for the risk that the "old days" return and interest rates finally go up instead of down.

It's best to consider an example. A household with an average disposable income that purchased a median Auckland home a month ago for $1,120,000 with a 20% deposit would have a debt servicing ratio of roughly 42% at current interest rates (including principal repayments). That's already up there. A scenario in which mortgage rates jag up to around 5% would see debt servicing costs rise to 53% of income, all else being equal.

That's at the upper limit of what is considered manageable. Albeit these metrics would look better for homeowners outside of Auckland (where house prices are lower) or for borrowers with a larger deposit.

Where are the sensitivities? – Mortgage refixing

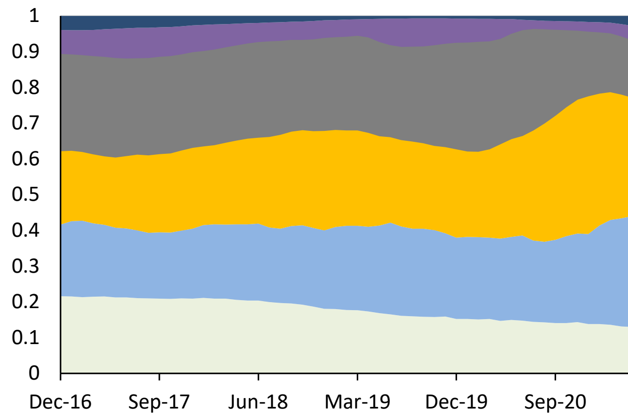
Data on mortgage fixing suggest households are quite sensitive to the risk mortgage rates rise over the coming 12 months. The boom in mortgage lending post-COVID has been mostly for relatively short fixed-rate terms. The average duration of outstanding mortgage debt (including floating) has fallen to around 9½ months. A full 77% of all mortgage debt is due to reset onto new rates over the coming year (including floating debt, chart opposite).



Source: ASB, RBNZ

[3] Data (from RBNZ) do not include principal repayments.

Still, our forecasts, both for official interest rates and mortgage interest rates, point to only a gradual increase from here. Households have time. But fixing a greater portion of your mortgage seems prudent for those worried about higher interest rates over coming years. Mortgage rates for longer terms are higher than for shorter terms. But they are still very low relative to history and might be worthwhile given a borrower will be protected from higher rates for longer. See our latest Home Loan Rate Report for more.



What about the macro implications?

So at an aggregate household level, there seems to be plenty of buffer to accommodate higher mortgage rates. But what about the implications on the economy writ large? Or, in more technical language, if the financial stability issues from rising mortgage rates seem manageable, what about the monetary policy effects?

The higher debt burden we mentioned above is going to give the Reserve Bank more bang for its buck in slowing down some parts of the macroeconomy when it does come time to lift interest rates. This is likely to temper the pace of OCR hikes, all else equal.

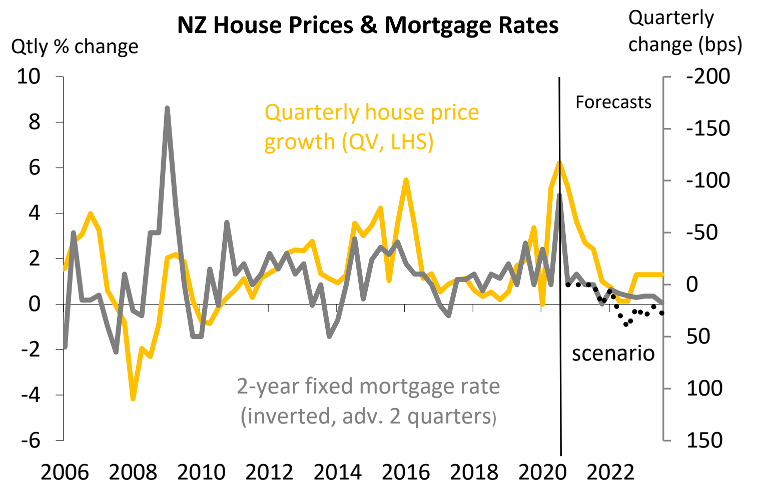
A rough cash flow at risk-style analysis (a tool used in treasury risk management) highlights the point. On our calculations, a scenario in which mortgage rates lift around one percentage point to 4% would see an extra approximately $3.1b sucked out of mortgage-holder's pockets annually. For reference, that's equivalent to about 1.6% of total annual disposable income, or 3% of annual retail spending in NZ. So not immaterial. However, these numbers will overstate the impacts a little, as higher interest rates will obviously put cash back into the pockets of savers, who might feel inclined to spend more.

House price tailwind flipping into a headwind

Finally, there's the impact on the housing market itself to consider. Falling interest rates have been one of the key drivers of the house price boom we've seen over the past 18 months. We expect this tailwind to soon flip into a light headwind, joining the likes of rising housing supply, tighter credit conditions, and reduced investor enthusiasm for housing.

Our 'rule of thumb' mortgage rate model has served us pretty well. It shows that the impulse from a *change* in mortgage rates usually goes on to impact house prices around six months later.

The chart shows that a slow upward grind in mortgage rates over the next few years should, in the least, slow the rate of house price inflation. In fact, the model shows that, if anything, house price inflation could slow a little faster than we are forecasting (15% yoy by end 2021, 2% by 2022) based on our mortgage rate forecasts alone. A scenario in which mortgage rates rise faster than we're expecting – to 4%, say, by end 2022 (the dotted black line) – would be consistent with some small quarterly falls in house prices.



Source: QV, ASB

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