THE WALL STREET JOURNAL.
WSJ.com

February 26, 2014, 10:34 AM ET

Why Higher Interest Rates Could Depress Housing Turnover

ByNick Timiraos

Record declines in home prices are a big reason housing turnover has been so muted in recent years, but low interest rates could serve as an additional — and underappreciated — contributor to the depressed level of homes being offered for sale, according to a forthcoming paper from researchers at **DePaul University**.

Bloomberg News

As interest rates begin to rise from their record lows of the past two years, more homeowners with a 3.5% rate will find it less appealing to sell their home when faced with buying their next one at, say, a 5.5% or 6% rate. Millions of homeowners could face so-called "lock in" from low interest rates, especially if rates rise sharply in the coming years, potentially curbing housing demand.

The American economy remains particularly exposed to this risk because of the popularity of fixed-rate mortgages, which also shield borrowers, of course, from higher payments during a rising interest rate environment.

The potential for lock-in arises because homeowners that refinanced at ultralow interest rates face a "higher payment on the same mortgage amount," says **Geoff Smith**, director of the Institute for Housing Studies at DePaul University in Chicago. "You'd think that would be a disincentive to trade up or to move in some cases."

DePaul researchers **Patric Hendershott**, **Jin Man Lee** and **James Shilling** looked at mortgages outstanding between 2005 to 2011 in Cook County, Ill., which includes Chicago. Their simulation modeled a one percent increase in interest rates in each of the coming three years, along with a 10% increase in home prices.

The result? Even though rising prices will free more “underwater” homeowners, or those who owe more than their homes are worth, to list their homes for sale, it wouldn’t be enough to offset the potential number of households who don’t want to sell because they’d have to trade up to a much higher interest rate.

The research found that a three percentage point increase in rates over three years would reduce housing turnover by 75%. Moreover, a 10 percentage point increase in the number of households locked-in due to low interest rates would result in a 29% decline in housing turnover.

The analysis looked at different submarkets, breaking Chicago into three tiers. Because households in the weakest third of the market were least likely to take advantage of low interest rates over the past few years because more homeowners were underwater—and therefore unlikely to refinance—weaker markets may face less of an interest-rate “lock-in” effect.

The strongest third of the market, meanwhile, faces higher potential rates of rate “lock-in” because more of these households refinanced. The DePaul simulation forecast a 16 percentage point increase in a rate lock-in for the weakest third of all markets, to 17% of all borrowers in those markets, compared to a 35 percentage point increase in rate lock-in for the strongest third of all market, to 42% of all borrowers.

Mortgage rates fell to record lows in 2012 and stayed near record lows through May 2013 as the **Federal Reserve** embarked on its third round of bond purchases, known as “quantitative easing,” to reduce borrowing costs for American companies and households in a bid to stimulate economic growth.

Because interest rates have mostly drifted lower over the past 30 years, the U.S. economy doesn’t have any recent experience with the potential side-effect of rate lock-in. But research indicates that when rates on the 30-year fixed-rate mortgage rose from 10.1% to 17.8% between 1978 and 1981, household mobility fell 15% for every two percentage point increase in rates, according to research published by **John M. Quigley** of the **University of California, Berkeley**.