The Washington Post

Back to previous page

Rising interest rates slow down housing sales

By Dina ElBoghdady, Published: March 21

The super-low mortgage rates that tens of millions of Americans locked in during the refinancing boom are now discouraging many of these borrowers from buying another home and giving up those loans.

The multiyear refinancing craze, which included some of the lowest rates ever recorded, freed up cash for borrowers to sink into the economy. But refinancing activity began receding last spring, and rates have been rising since. The average rate on a 30-year, fixed-rate mortgage hit 4.32 percent this week, up from 3.54 percent a year ago, according to mortgage-finance firm Freddie Mac, based in McLean, Va.

The higher rates, soaring home prices and a tight inventory have kept potential buyers on the sidelines, hurting the sales of previously owned homes and undermining the recovery of the housing market, a huge contributor to economic growth. Homeowners who are reluctant to move and lose their low rates — a phenomenon that economists call interest rate "lock-in" — could slow the churn of home sales across the country.

A healthy turnover of homes is critical to a robust housing sector, enabling critical first-time home buyers to enter the market and existing homeowners to move or trade up. But housing experts worry that interest rates, which are expected to gradually rise to nearly 6 percent by late next year, will chill enthusiasm for home purchases. They say they're already seeing signs of that, most recently among existing homeowners.

It's too early to quantify the impact of the lock-in phenomenon. But it's happened before and could happen again, say researchers who have studied the effects of rising rates on housing turnover. Statements by Federal Reserve Chair Janet L. Yellen this week sparked investor fears that the agency could soon begin allowing a key interest rate to rise, helping push mortgage rates even higher.

Ella Lore said she and her husband are fence-sitting. Now that their daughter is studying abroad, they would like to sell their D.C. home, buy a two-bedroom condominium and rid themselves of the hassles and costs of maintaining a large home.

But when they did the math, they discovered that they would be paying about the same amount each month for considerably less space partly because of rising mortgage rates, Lore said. The couple refinanced into a loan with a 2.8 percent rate in 2012. Now, with a new loan, they'd get a 4.25 percent rate.

"At some point I thought: 'I don't know whether we're going to go ahead with this,' " Lore said. "We're leaning toward buying, but I'm just not sure."

Their real estate agent, Joan Caton Cromwell of McEnearney & Associates, said that she expects the issue to surface with other potential buyers as interest rates edge upward.

"I don't think people are going to give up these interest rates easily, particularly younger people," Cromwell said. "Buyers who are under 40 have lived through a period of very low rates. It scares them more than somebody who bought a house in the '80s, for instance, and remembers when rates were close to 20 percent."

The interest rate lock-in effect took hold back then, according to research by the Institute for Housing Studies at DePaul University. Between November 1978 and November 1981, when the average monthly rate on a 30-year, fixed-rate mortgage jumped from 10.1 percent to 17.8 percent, sellers retrenched. Household mobility fell by 15 percent for every 2 percent increase in rates, according to the study.

Patric Hendershott, one of the study's co-authors, said that a significant uptick in mortgage rates in coming years could have the same effect, especially in areas with strong housing markets that are teeming with people who had enough equity to refinance their homes during the past three to five years.

"An increase of one percentage point is going to affect a few people at the margin," Hendershott said. "But if you start talking two or three points, if rates hit
6 or 7 percent, I think that certainly would have a big effect."

In their study, Hendershott and his colleagues created a statistical model of housing turnover from 2005 through 2011 in Illinois' Cook County. It found that if home prices rose by 10 percent in one year, and interest rates climbed one percentage point annually for the following three years, the housing turnover in strong markets fell 75 percent.

The model was meant to simulate changes that are underway as the Fed scales back its support of the economy in general, and housing in particular.

Late into the 2008 financial crisis, as part of a broad push to stimulate the economy, the Fed began buying a sizable chunk of mortgage-backed securities. The purchases pushed interest rates reliably below the 6 percent mark for the first time in years, sparking a refinancing boom. The Fed conducted two more rounds of purchases — the most recent one beginning in fall 2012 — that caused mortgages rates to fall to some of the lowest levels ever recorded. One day in November 2012, the average rate dropped to 3.25 percent, an all-time low.

But when the Fed signaled in May that it would soon start scaling back its purchases, mortgage rates started climbing. Since then, the central bank has suggested that it will wrap up the program by the end of the year. This week, it began laying the groundwork for the first increase in short-term interest rates since before the recession. The move sent ripples throughout the stock and bond markets and is expected to cause mortgage rates to jump even faster.

At Freddie Mac, which has tracked interest rates for decades, economists expect that the average rate will climb to just shy of 5 percent by year's end on a 30-year, fixed-rate mortgage and hit nearly 6 percent by the end of 2015.

"I don't see sharp jumps," said Frank E. Nothaft, Freddie Mac's chief economist. "I predict the Fed will move gingerly and continue to promote a lower interest rate environment."

Still, Jim Peterson can't bring himself to buy another house anytime soon.

Peterson, a Marine based in Quantico, Va., has been ordered to move to San Diego for recruiting school. He's decided to sell his home in Fredericksburg, give up his 3.25 percent interest rate mortgage and rent. He figures that a monthly mortgage payment will be neck-and-neck with monthly rent in most areas.

"When interest rates go up, I'm pretty confident that mortgage payments will surpass rent," he said.

Some housing analysts say that potential buyers need to recognize that rates remain at historically low levels. They also say that as the economy improves and consumers feel more upbeat about their job security and earning potential, those factors will trump incremental increases in rates in the home-buying decision.

Greg McBride, chief financial analyst at Bankrate.com, said that the people who are most likely to get squeezed by rising interest rates are first-time buyers who are sensitive to affordability.

"For them, the hurdles are more psychological," McBride said. "But what are they going to do? Stay in a smaller house in a bad neighborhood with lousy schools so they can show their neighbors their great interest rate?"

Ylan Q. Mui contributed to this report.