Finance

Will low home loan rates lead to lock-ins?

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SUPPOSE your mortgage has a low interest rate - lower than you expect to see again. Would you stay put, no matter what, just to keep that low rate? Or would you be willing to sell your home and buy another with a new mortgage at a higher rate?

MORTGAGE lock-in is the state of having a home loan with such a low interest rate that the homeowner is reluctant to sell the home because buying another home would require getting a mortgage at a higher rate.

The question might seem highly personal. But in fact, what's known as mortgage lock-in is on a lot of people's minds because it could have important implications for home sellers and buyers, as well as owners.

There are three things about mortgage lock-in.

First, a rise in mortgage rates tends to be followed by a drop in home sales.

Second, some homeowners stay put so they can keep their low mortgage rates.

And, third, most home purchases are driven by personal factors that eclipse interest rates.

So, what will happen as interest rates and home prices rise at the same time?

Researchers at the Institute for Housing Studies at DePaul University in Chicago, for a February 2014 research brief, found that their simulation model wasn't favourable for housing markets.

"The growing number of locked-in households will, in turn, cause a deep reduction in housing turnover, or sales activity, and this reduction will be particularly steep in the strongest housing markets," the researchers wrote.

The researchers' conclusion might sound dire. But, in fact, the effect of mortgage lock-in alone is likely to be small, says Sam Khater, deputy chief economist for CoreLogic, a residential property information, analytics and services company in Irvine, California.

That's because, Khater says: One-third of homeowners don't have a mortgage, so lock-in doesn't apply to them; Most people move in response to changes in their employment, family situation or lifestyle, not housing costs or interest rates; Mobility has declined during the past 30 to 40 years across all demographic groups for economic reasons that aren't limited to housing or interest rates and; Mortgage rates affect housing affordability, so some buyers might downgrade their expectations. But they still will buy.

"The impact of rising rates will be bigger if it's over a shorter-time horizon, but that impact is not due to a lock-in effect. It's due more to the shock of higher rates," Khater says. "Households still want to buy. They've made a decision. The higher rate simply reallocates where they move to."

The last outbreak of US mortgage lock-in happened from the early 1970s to the early 1980s, Khater says. Even as interest rates remained elevated after the 1982 recession, home sales remained strong.

The supply of homes for sale is increased by newly-built homes sold by builders, who aren't affected by rate lock-in. Brand-new dwellings represent a small portion of overall home sales, though.

Ken Fears, manager of regional economics and housing finance for the National Association of Realtors, says rate lock-in "will certainly have an effect," but the effect is likely to be marginal and not significant in the near term.

That's because interest rates have remained relatively low and homeowners typically sell their home only every nine years, on average.

"A lot of people who bought their home that long ago have a large amount of equity," Fears says. "When they trade up, they'll have a smaller balance and lower rate, unless they refinanced."

For move-up buyers who end up with higher monthly payments, the increased costs are offset by the new homes' greater desirability.

"People will look at their new monthly payment relative to their current payment," Fears continues. "But they'll juxtapose that next to what they'll get: more bedrooms, a better school system, shorter commute or new job. The alternative is to buy another car, add on to their house or pay for private schools. At the end of the day, it's not just about the rate."