Base rate rises could weaken market sentiment

By Bob Pannell 21st May 2018 4:05 pm

Although the Monetary Policy Committee decided to hold rates this month, there is still a strong consensus that the future direction of interest rates will be gently upwards for the foreseeable future. Roughly speaking, one or two quarter-point increases in each of the next three years.

Most existing mortgage borrowers should not struggle with such a gentle pace of monetary tightening, not least because fixed term products will cushion many households for a while.

But how might such changes affect those looking to buy homes and the wider state of the housing market?

There are two reasons for suspecting that even modest further rate increases in the coming years have the potential to weaken market sentiment.

Firstly, there are limits to how far mortgage spreads can narrow, especially now that the Bank of England's Term Funding Scheme – which provided £127bn of cheap four-year funding to banks – has ended. In contrast with last November, when the impact from the hike in base rate was blunted by competition between mortgage lenders and narrowing spreads, future base rate changes are more likely to feed through into higher mortgage rates.

For a typical first-time buyer, each quarter-point increase in mortgage rates would push up monthly mortgage bills by about £20; potentially a meaningful sum for households that are looking to stretch themselves in order to buy.

The second point relates to the macro-prudential framework, and the two housing levers the Bank of England's Financial Policy Committee uses to influence the trajectory of the housing market.

One of these – the affordability test – requires lenders to check that mortgage bills would still be paid if interest rates moved up by 3 per cent during the first five years of the loan.

Last summer, the FPC made the link between base rates and its affordability test a formal one.

Last November's rate increase is likely to have pushed up the stress rates used by firms from about 7 per cent a year ago to nearer 7.25 per cent. And stress rates will go up more if there are fresh base rate rises.

What sounds like a geeky point has the potential to diminish the ability of households to stretch their income multiples, one of the key developments associated with the housing market's recovery over recent years. This is an area to watch, as even small downward adjustments in permitted income multiples can materially reduce a borrower's buying power and/or increase deposit requirements.

The Bank of England is alert to the potential read-across to income multiples, and has signalled that it would review its housing levers as base rates approach 1 per cent. But for now the mechanistic link is in place, and seems likely to constrain borrowing as base rates move higher.

Although longer-term fixed rate mortgages are currently exempt from the FPC's requirements, and the popularity of five-year deals has grown significantly over recent years, they are not suitable for everyone and they are more expensive than variable and shorter fixed-term products. Those opting for longer-term fixes face higher upfront mortgage bills, and this will also dampen overall demand to some extent.

So, we face the prospect of base rate increases feeding through more fully to mortgage rates, and more stringent affordability tests making it harder for purchasers to get the mortgage finance they need.

With higher interest rates also likely to be negative for household sentiment more generally, even modest rate hikes might be enough to weaken borrower demand, nudge house price expectations lower and cause lenders to shade down their risk appetites for higher LTV business and 'fully-priced' areas of the UK.

In conclusion, base rate increases that would have seemed trivial a generation ago may now be all that is needed to change the direction of the housing market and lending activity.

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