Spotlight 1: The Impact of Rising Interest Rates on Housing Costs

By Rosen Chowdhury and Max Mosley

How have fast-rising interest rates affected housing costs across the United Kingdom? What has been the effect on housing costs arising from uncertainty not only about the path of monetary policy but also lending conditions and mortgage providers withdrawing a range of mortgage products? With interest rates forecast to rise to 5.5 per cent, we explore what the short- and long-term implications are for mortgage holders, and whether we can observe any pass-through impact on renters.

Short-term Implications for Mortgage Holders

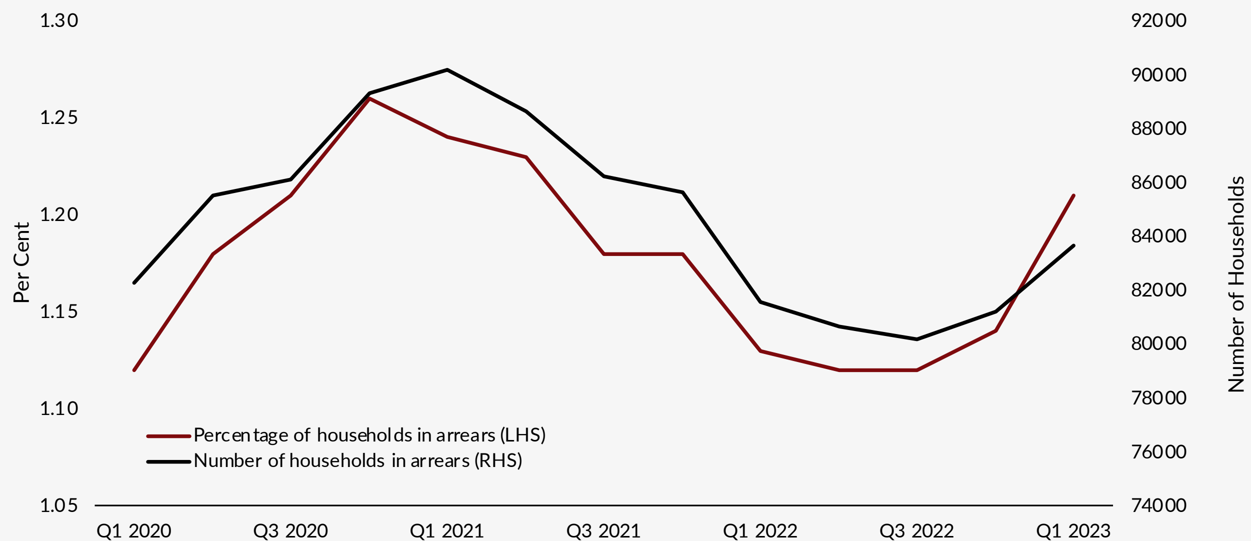
The Bank of England (BoE) has used both conventional and unconventional policy tools (such as Quantitative Tightening) to address persistent inflationary pressures. Although the impact of the latter policy on the financial and housing market is still uncertain, it is thought to be minimal owing to additional measures taken by the BoE such as the introduction of a new short-term repo (STR) facility and owing to the availability of excess reserves in the banking sector. However, the effects of the traditional policy tool (the interest rate) have already been felt by mortgage holders, transmitted via direct (interest rate channel) and indirect (balance sheet channel) channels in the form of higher mortgage costs.

Furthermore, the rising policy rate transmitted via the indirect channels reduces households' net worth (including housing value), increasing the information asymmetry between borrowers and lenders, raising mortgage spreads and resulting in higher mortgage rates (Chowdhury et al., 2022; Iacoviello and Minetti, 2008).

The impact of these effects is presently felt by around 4 million households, including those on variable rates facing an immediate increase in repayments, and the 3 million households nearing the end of their fixed-rate deals. For these households, average mortgage interest costs have risen from approximately 2 per cent last year to around 6.5 per cent currently (BoE, 2023). As an example, a household borrowing £300,000 on a 25-year mortgage would now face a 50 per cent rise in monthly repayments – from £1,200 to £1,800 – as a consequence of interest rates increasing from 2 per cent to 5.25 per cent.

If the Bank rate were to peak at 6 per cent by the end of 2023 or in early 2024, we project that 1.2 million households would run out of savings in 2024 as a direct consequence of rising mortgage repayments (Mosley, 2023). This would take the total number of households with no savings to around 7.8 million. Using data from UK Finance, we show in figure S1 that the number of households with mortgages in arrears has been rising steeply since the third quarter of 2022, with the total number approaching 85,000 compared with 80,000 in the third quarter of 2022.

Figure S1 Percentage and number of households in mortgage arrears



Notes: Arrears defined as outstanding payments worth over 2.5 per cent of total balance.
Source: UK Finance (May 2023).

Previously, households applying for a mortgage were subject to affordability stress-tests, assessing their ability to withstand a 3 percentage point increase in interest rates. Given that rates have risen by more than this, households are now in an environment they would not have been expected to withstand this impact without some adjustment.

As a result of the existing heterogeneity across regional economies and housing markets in the United Kingdom, the regional impact of monetary policy tends to diffuse mainly via demand-side channels, i.e. the balance sheet channel (Dow and Montagnoli, 2007). Owing largely to the lower debt carrying capacity, peripheral regions such as the North East and Wales are worst affected by the current contractionary monetary policy (Mosley, 2023). The large increase in disparity in household wealth between core and peripheral areas can be partly attributed to Large Scale Asset Purchase (LSAP) schemes deployed during the Covid-19 period.

The savings accrued during the Covid-19 pandemic for middle to higher income households are acting as a temporary buffer before households are unable to afford their repayments and enter arrears. The data used in figure S1 show two notable trends. The first is the fast pace of the increase in the total number of households in mortgage arrears, at about 6,000 over the past four months. As a proportion of all households in mortgage arrears, this rise takes the total percentage near to the peak seen during the mortgage holiday in 2020.

The second is that the greatest rise is in those households with arrears with a range of 2.5 per cent to 5 per cent of the total balance, which is the lightest arrears band. This suggests that there is growth in new cases of people who struggle to afford their repayments rather than households that already struggled in the past, for example during the pandemic. Thankfully, despite a strong increase, the overall number of households in mortgage arrears remains low. But this data, coupled with our projections about the drawing down of savings, suggests that the number of households in mortgage arrears is likely to increase over the next 12 months.

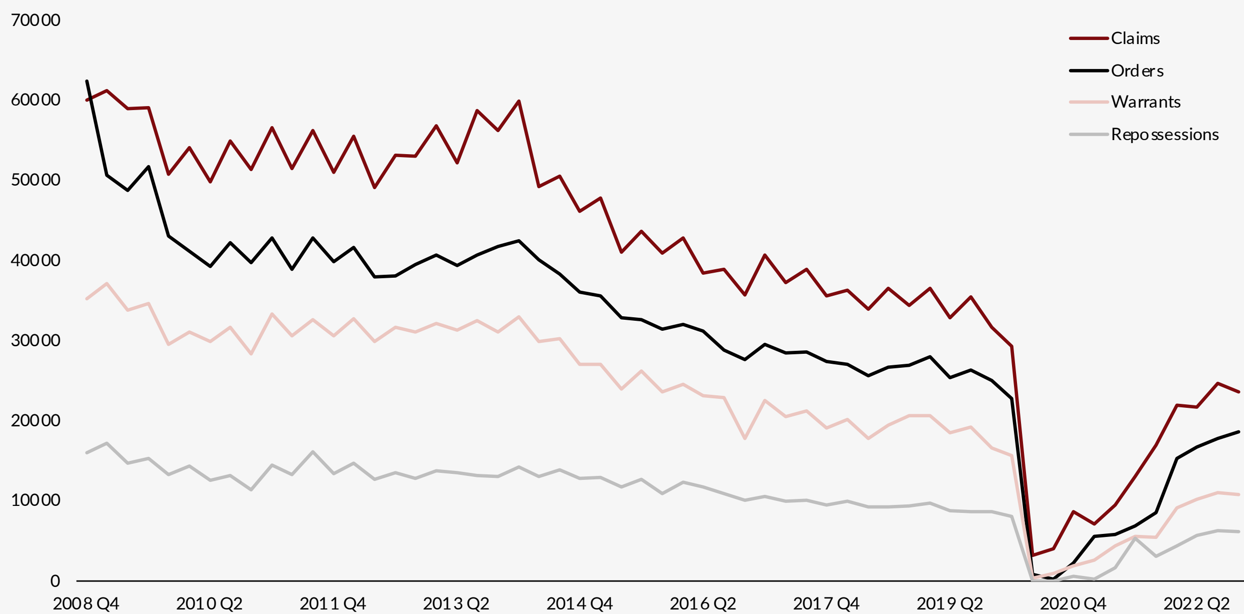
While the above demand-side channels emphasise heterogenous effects, the same is not true for supply-side effects. This is because the United Kingdom has a uniform mortgage market, and hence potential heterogenous effects of the current contractionary monetary policy via supply-side monetary transmission channels (such as the bank lending or the bank capital channel) on regional mortgage markets are likely to be limited.

Long-term Implications for Mortgage Holders

There are several factors that should limit the long-term impact of higher interest rates:

1. The likelihood of this rise in arrears resulting in repossessions remains small. In relation to the rise in arrears seen in the first quarter of 2023, just 750 households and 410 buy-to-let mortgaged properties were taken into possession. Although this is 50 per cent higher than in the previous quarter, it remains small as a proportion of the total number of households with mortgages. The number of claims and subsequent repossessions has increased, but it is historically low, reflecting lenders' preference for payment plans over repossession (figure S2). In short, repossession claims have increased rapidly since the pandemic but remain below historical standards.
2. Higher house prices have provided a protective cushion. Demand from homebuyers seeking more space surged during the pandemic, raising house prices and giving millions of homeowners greater equity in their properties, which has potentially reduced the cost of new home loan deals. The stamp-duty changes from 2020 to 2021 would have further elevated demand and thus prices.
3. Previous regulations have limited the number of individuals facing unmanageable loans. Agreed measures between lenders, the Chancellor, and the Financial Conduct Authority (FCA), including loan-to-income limits and responsible lending requirements, have effectively limited household debt build-up in the mortgage market, increasing borrower resilience and reducing the prevalence of payment difficulties. Although interest rates have risen beyond typical stress-test scenarios, these measures have helped to minimise the number of individuals facing unmanageable loans.

Figure S2 Headline possession actions (repossessions for all claims, 2008Q4 – 2022Q4)



Source: Mortgage and Landlord Possession Statistics (Ministry of Justice), Q4 2022.

4. Borrowers are responding flexibly to rising interest rates. Lenders are reporting that borrowers are exploring options such as extending mortgage terms or adjusting plans for tighter affordability conditions. Despite rising borrowing costs, jobs remain relatively secure, and wages are now rising to offset a higher proportion of real-income loss, allowing some individuals to afford higher mortgage payments. Lenders often attribute the most common reasons for falling behind on mortgage payments or facing home repossession to life-changing events such as job loss or serious illness, rather than rising interest rates in and of themselves.

5. Inflation reduces the real-term value of mortgage debt in the long run, making borrowers financially better off as wages catch up with inflation. The present impact of higher mortgage interest rates poses a short-term cash-flow problem rather than a long-term wealth challenge. Policy should be targeted at helping affected households smooth out the short-term impact, as we argue in the section on policy after this Spotlight.

Rental Costs

Economic theory suggests that common forces such as changes in housing demand can drive both house prices and rents. For example, the expansion of Working From Home (WFH) since the Covid-19 pandemic has increased demand for housing, raising both house prices and rents (Kmetz et al., 2022). To the extent that the stream of current and future rents reflects the fundamental value of a house, house prices can be a leading indicator of future rent inflation (Lansing et al., 2022). Thus, changes in the monetary policy stance can affect both house prices and rents by reducing housing demand.

Besides structural factors, the current rise in rental cost can be attributed to causes relating to inflationary pressure, passed on to tenants by landlords who face rising mortgage costs. At an aggregate level, the literature suggests that the impact of monetary policy on the rental price tends to be negative. But since the impact is only visible after a long lag, approximately after

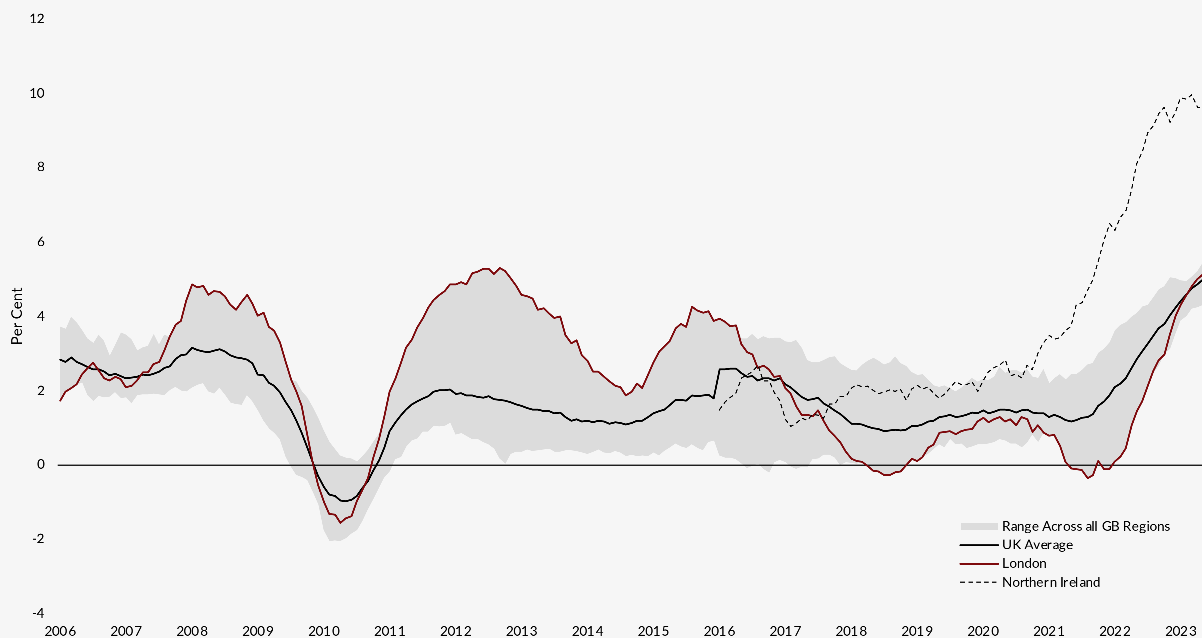
two and a half years following the first rate rise (Liu and Pepper, 2023), there are concerns over the spill-over effects from high mortgage costs to renters in the buy-to-let segment of the housing market. Buy-to-let mortgages often come with higher interest rates compared with those for homeowners.

However, a substantial number of landlords, covering around 2 million out of around 5.5 million properties in the private rental sector, own their properties outright without any mortgage. This means that some landlords may be mostly immune to the impact of interest rate rises. While tenants in non-mortgaged properties may benefit from landlords not passing on higher mortgage rates through increased rents, all landlords face rising costs and this has an upward effect on the market rate for rent.

For buy-to-let landlords, the higher mortgage interest payments, and other structural factors may further strain their incomes which could potentially lead them to sell properties, putting downward pressure on house prices, or pass on the increased costs to renters. Similar to other types of borrowing, buy-to-let mortgages are subject to affordability testing which would reduce the likelihood of renters living in a house with an unaffordable mortgage.

Although in the first half of the 2010s rental costs were increasing in London further than the UK average, the second half of the decade shows rents in London beginning to cool compared with the UK average. Growth rates of rents in both London and the wider country have now converged somewhat over the past year, against the backdrop of a strong surge in rental costs across the country (figure S3). Northern Ireland remains an outlier, with the growth in rental costs considerably exceeding other UK regions. The last time rental costs across the UK increased as sharply as they have done over the past year was in the aftermath of the 2008-09 financial crash.

Figure S3 Annual percentage change in private housing rental prices across the UK



Notes: The data are not seasonally adjusted. Wales is included in the UK average from 2010 onwards, Scotland from 2012 onwards and Northern Ireland from 2016 onwards. Northern Ireland data is not included for last two months because it is an outlier. The latest two monthly estimates are provisional and subject to revision in line with IPHRP's revision policy. Source: ONS.

The rise in rental costs seems disproportionate to the rise in mortgage costs given the small number of landlords with buy-to-let mortgages. Therefore, not all of this rise can be explained by rising mortgage costs. Arguably, this is also a reflection of changes to regulations in the rental market, such as mortgage costs no longer being tax deductible (now a landlord can only claim relief on the interest component) or the Renters Reform Bill which has provided stronger safeguards on housing quality. These changes have made the rental sector less attractive to landlords, which may lead to some withdrawing their property from the market, reducing supply and increasing rents. To what extent this is a key driver of this rise, or whether landlords are raising costs for other reasons, will require further research.

Is Housing Becoming Unaffordable?

Whether these rises in rental costs present a challenge on affordability is a complex question and not one easily answered with the trends in the available data. This will depend on the level of rents relative to income. In March of 2020, the value of rental costs was approximately 27 per cent of gross median earnings. In London, median rents were more than double, at around 47 per cent of median earnings, above accepted measures of affordability (Whitehead and Meen, 2020).

The number of rental properties affordable to households in receipt of housing benefit is increasingly limited given the decision to freeze the amount households can receive. The Local Housing Allowance (LHA) determines the maximum amount a local authority can offer for housing benefit. These rates were previously set equal to the median rent in a local area, then cut to the 30th percentile of rents in 2011.

In April 2013, the Local Housing Allowance (LHA) rates were increased based on the Consumer Price Index (CPI). Subsequently, in 2014 and 2015, they were further raised by a maximum of 1 per cent (excluding areas with the highest rent increases, which were exempt from the 1 per cent cap). From April 2016 onwards, the LHA rates remained frozen for four years. In April 2020, the LHA rates were adjusted to align with the 30th percentile rent levels, but since then, they have remained unchanged in terms of cash value.

The consequence of freezing the cash-value of housing benefit is a fall in the number of rental properties that are affordable to a household in receipt of the benefit, which is driven by the rapidly increasing cost of rental homes. Since 2020, the cost of rental homes has increased, but the amount a household can receive in housing benefit has remained the same. The growing disparity between the two has resulted in a strong fall in the number of affordable rental properties, from 23 per cent in the first quarter of 2020 to just 5 per cent today (Waters and Wernham, 2023).

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