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Source: *The Business Times*, p1
Date: 11 July 2022

Rising interest rates and private home prices could push some out of market: IREUS

As inflation continues to surge, the US Fed has announced significant interest rate hikes to bring prices down to a sustainable level

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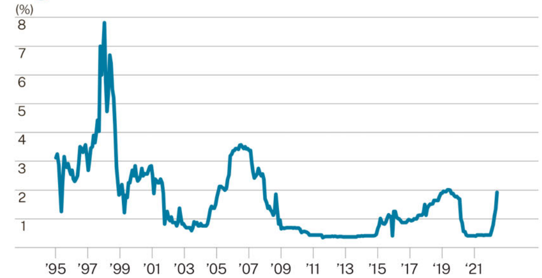
A COMBINATION of rising interest rates and property prices is bound to impact buyer affordability - the question is where that tipping point lies. A recent analysis has shown that buyers are still able to afford private homes despite recent rate hikes, but depending on the loan tenure, they may start getting priced out of the market if mortgage rates reach 3.5 per cent and beyond.

This scenario is based on modelling done by the Institute of Real Estate and Urban Studies (IREUS) at the National University of Singapore, using a proxy household at the top 30th percentile of income. In general, the top 30 per cent of earners are mainly the ones who can access private homes.

As inflation continues to surge, the US Federal Reserve has announced significant interest rate hikes to bring prices down to a sustainable level. Since lenders here take their cue from the Fed, Singapore interest rates have risen as well.

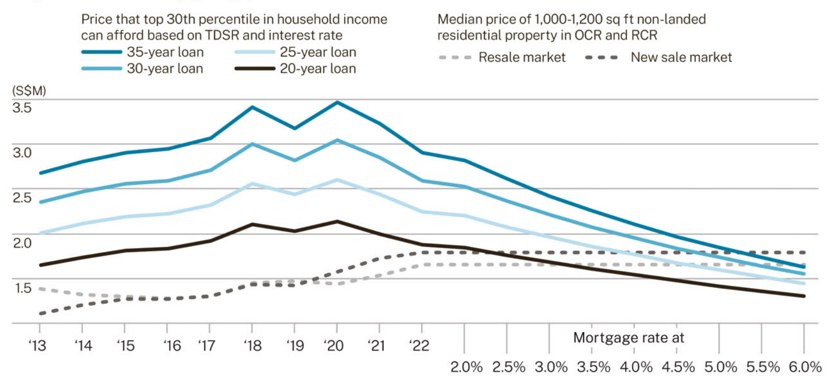
The 3-month Singapore Inter-Bank Offer Rate (Sibor) reached about 1.91 per cent on June 28, 2022, closing in on the last high of 2 per cent recorded on May 31, 2019 (see Figure 1).

Figure 1: 3-month Sibor



Source: Refinitiv, Association of Banks in Singapore

Figure 2: The tipping point



With the Fed expected to announce further rate increases, the Sibor may likewise rise to levels last seen in 2005 and 2006, 2 years before the Global Financial Crisis, said Lee Nai Jia, deputy director of the research institute.

"To many younger borrowers who have yet to experience a recession, bank interest rates have reached uncharted territory, and may force some to recalibrate their homeownership plans," he told The Business Times. "On the other hand, older homeowners who have experienced the Asian Financial Crisis and other recessions will be concerned whether the rates would reach the overwhelming levels between 1997 and 1998."

The 3-month Sibor hit 7.75 per cent in January 1998.

Meanwhile, private property prices have been steadily ascending. The Urban Redevelopment Authority's (URA) Q2 flash estimate for its overall price index for private homes released on July 1 is up 3.9 per cent from Q4 last year.

This follows 2021's full-year increase of 10.6 per cent, with private home prices having risen 18.6 per cent since bottoming in Q1 2020, at the onset of the Covid-19 pandemic.

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Property consultants generally expect URA's index to increase between 5 and 10 per cent for the whole of 2022.

Given that interest rates started off at a low base, Dr Lee said there are some quarters arguing that the effect on prices and demand may not be significant. For example, the most recent Sibor uptrend started on a base lower than in previous climbs, and it is not obvious that this current surge will exceed previous peaks.

"However, this perspective is a reductionist focus on interest rates alone and overlooks the fact that homes today are far pricier than back then," he pointed out. "In absolute dollar terms, a 1 per cent rate rise today is substantially more than a 1 per cent rise back in 1997."

To see how close private home prices are to a tipping point, IREUS created a proxy case to examine the impact of interest rate hikes on what a private home purchaser can afford.

The institute constructed its case based on data from the Singapore Department of Statistics and URA's Real Estate Information System.

The household income from work, excluding employer's Central Provident Fund contributions, is assumed to be at the top 30th percentile and the same as in 2021. Also, the household does not have credit card debt, is not saddled with other loans and has sufficient savings for a down payment.

The mortgage rate is pegged at 1 per cent + 3-month Singapore Overnight Rate Average. The floating rate was used as an indicator of

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debt commitment, as the interest charged for fixed rate mortgages is not publicly available and varies according to individual circumstances.

The household is assumed to be a first-time home purchaser and will buy a 1,000 to 1,200 square foot non-landed private home (all land tenures and excluding executive condominiums) in the Outside Central Region (OCR) or Rest of Central Region (RCR). The Core Central Region was omitted as home prices there are more prohibitive and considered likely to only be within the reach of high net worth individuals.

The home price that a household can afford is therefore the loan amount (after factoring in the Total Debt Servicing Ratio, which is currently 55 per cent) plus the initial down payment.

Based on loan tenures of 20, 25, 30 and 35 years, the modelling shows that the price buyers can afford based on the loan amount they can take, is still above today's median-price OCR and RCR homes, despite the higher interest rate in July (see Figure 2).

However, the buffer has thinned considerably since 2020, especially for those seeking to purchase new homes on the primary market, as new homes are now pricier.

For a 20-year loan for instance, the buffer of over S$568,000 between new OCR/RCR homes and the price which households can afford in 2020, has shrunk to under S$87,000 - an 85 per cent fall.

At the longest possible loan tenure of 35 years, the buffer drops from about S$1.9 million to S$1.1 million, or about 41 per cent.

If the mortgage rate reaches 2.5 per cent and beyond, households at the top 30th percentile income on a 20-year loan would not be able to pay the median price for a new unit in the RCR and OCR. If the mortgage rate hits 3.5 per cent, these households would not be able to afford median-price units in the resale market.

On a 35-year loan however, such households would be unable to pay the median price for a new unit only if mortgage rates reach 5.5 per cent and would also be priced out of such units in the resale market if rates hit 6 per cent.

"We assume the buyer has no debt outstanding. However, if we factor in rising prices for cars and other goods, credit card bills and car loans should be higher for younger, aspiring households. This will further crimp the prices they can afford," said Dr Lee.

While a longer loan tenure reduces the borrower's monthly mortgage payments, it does mean the household will be coughing out more interest in the long run for the same loan quantum. It will also take longer for the homeowner to be debt-free.

"Given that prices of private homes are at a historic high, rising interest rates and decreasing disposable incomes due to rising prices further erode the affordability of homes at a faster pace," he pointed out.

Of course, IREUS' modelling is based on a first-time private property buyer. Those who own existing private apartments or Housing and Development Board (HDB) flats may be less affected by the higher interest rates if they were to move laterally or right-size, especially if they purchased their current homes between 2013 and 2017.

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"The capital gains and appreciation in equity will help partially offset the higher costs of debt," noted Dr Lee.

Also, housing in Singapore is still widely affordable, due to the availability of public housing.

"The price-to-income ratio for 4- and 5-room HDB resale and Built-To-Order flats remain below 5, which is a healthy level," he added. This means a HDB flat is priced about 5 times the annual income of the household.

"However, the government has to manage the mismatch of expectations, as young professionals tend to aspire towards private condominiums instead of HDB flats."