Risks from turnaround in interest rates threaten mortgage business

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Interest rates are going to turn around again!

But if higher interest rates are the only remedy – what can builders, savers, and banks expect?

Builders who have previously relied on variable terms or are facing follow-up financing, will experience hard times. After mortgage rates have almost consistently been below 2% over the past 6 years, there is now a risk of a considerable extra burden from rising interest rates.

Currently, mortgage interest rates are exploding: since September last year, rates for ten-year mortgage loans have almost tripled. One of the reasons is the market's expectation for the European Central Bank (ECB) to be forced into an even earlier and more pronounced interest rate turnaround.

Due to another significant key rate hike by the US Federal Reserve as well as the high inflation rate, many market participants foresee interest rates to rise to 1% by the end of the year. The turnaround in interest rates on the capital market is also reflected in the rapid rise in government bond yields. The market expects to see a 3% interest rate for mortgage loans with a 10-year fixed interest rate in the near future.

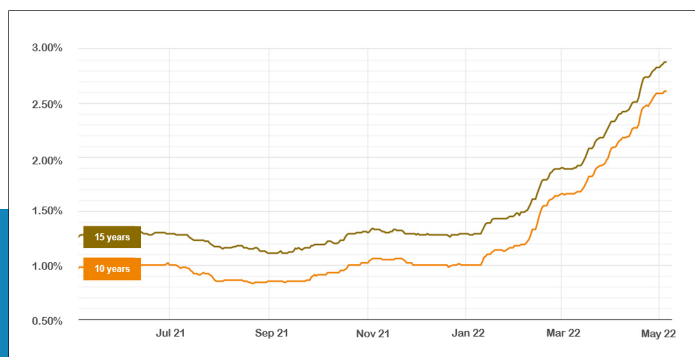

Fig.: Development of mortgage rates for the past year
Source: https://www.interhyp.de/ratgeber/was-muss-ich-wissen/zinsen/zins-charts.html#

And as if rising interest rates were not problematic enough, the situation is exacerbated by other aspects: on the one hand, a high inflation rate gobbles up the disposable income of households. On the other hand though, the demand boom in the real estate market could stall if fewer and fewer prospective builders and buyers can afford their own real estate. Experts fear that this will cause real estate prices to drop. This, in turn, means lower loan values for properties that serve as collateral.

Example

In the case of a fully repayable loan of EUR 300,000, 0.85% p.a., the annuity increases from EUR 2,608 to EUR 2,896. While the disposable income was at EUR 1,000 in the beginning of 2022, given an inflation rate of 7.3%, these EUR 1,000 will only have a purchasing power of EUR 931 by the end of the year.

There is no doubt that the general conditions for mortgages have deteriorated considerably within a very short period of time.

In this respect, it is important for banks to recognise the risk at an early stage and to be able to estimate the extent of the threat.

To this effect, the use of artificial intelligence (AI) can prove very useful: An AI is able to determine whether and to what extent the individual loan portfolio will be affected by an increasing default risk. For this calculation, the revenue and expenditure account for each mortgage loan plays an important role. The free income calculated at the time of the loan application is currently significantly reduced by inflation. Even if, contrary to expectations, the price drivers ease off or even disappear in the near future, the principle of cost stickiness will cause a permanently reduced disposable income.

Using AI, the combination of disposable income on the one hand and considerably increasing expenditure for loan interests on the other hand can be analysed and evaluated with regard to the expected increase in default risk.

Based on this, an action plan to reduce the default risk can be developed early on for individual borrower units. For example, a reduction in the monthly loan burden can be achieved by extending the term.

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