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Long-Term Fix-Rate Mortgage Loans Can Increase Affordability Significantly

Affordability of owner-occupied residential housing is a problem for many middle- and lower-income households. However, affordability can be significantly enhanced if the duration of the loan can be lengthened. For example, for a fully amortising loan of say $1 million at a 5% per annum rate of interest, the monthly payment for a 15-year mortgage loan including both interest and repayment of principal is $7,907.94, whereas it is only $5,046.88 for a 35-year loan. If the rate of interest is 3.5%, then the monthly payments are $7,148.33 and $4,132.91 respectively for a 15-year and a 35-year loan. We note that the monthly payment for a 35-year loan is only 63.8 and 57.8 percent of the monthly payment for a 15-year loan respectively.

Assuming that an entry-level starter home costs $2.25 million, and that a 10% down payment is required if it were owner-occupied, then a thirty-five year mortgage loan of $2 million at a rate of interest of 3.5% is quite affordable for a household with a combined total income of $20,000 a month, with a house payment of just slightly over 40 percent of household income. A 15-year loan will imply a house payment of more than 70 percent of combined total household income for such a household, which will put home ownership out of reach.

Thus, one important key to making owner-occupied residential housing affordable is to introduce long-term mortgage loans. A second important key is a fixed rate of interest. Middle- and low-income households typically have income streams that are relatively fixed and stable and are least able to bear the risks of a fluctuating rate of interest on their mortgage loans. Thus, to reduce the risks of interest rate fluctuations (and hence potential default on the mortgage loans) and to enhance the security of middle- and low-income households owning their own homes, mortgage loans with fixed rates of interest should be offered.

However, commercial banks are not able to offer long-term fixed-rate mortgage loans because they do not have fixed-rate deposits and their deposits do not have such long maturities. This is where a government policy bank can play a role—by issuing long-term fixed-rate bonds and using the proceeds to purchase qualified owner-occupied fixed-rate mortgage loans from the commercial banks. (In order to discourage moral hazard, the originating commercial bank will have to bear some residual liability during the first years of a mortgage loan.) A government policy bank such as a Home Loan Bank or a Mortgage Corporation can issue long-term fixed-rate bonds at quasi-sovereign rates to the public. The potential purchasers of these bonds will include insurance companies, retirement funds and social security funds, all of which have long-term money under their management.

It may be objected that these mortgage loans potential compete with the commercial banks. However, no commercial banks will be able to make long-term fixed-rate mortgage loans (remember the Savings and Loan Associations debacle in the 1980s in the United States). And the potential competition can be minimised by limiting the availability of such mortgage loans to owner-occupied residential housing units (thus investors and speculators will not qualify), putting a ceiling on the amount of the mortgage loan per residential unit that the Home Loan Bank or Mortgage Corporation can finance, say no more than $4 million and perhaps even on the size, say no more than 100 square metres.