Fixed-rate mortgage offers a safe haven

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June 23, 2010

As the Reserve Bank eyes the possibility of further rises in interest rates, John Kavanagh examines the pros and cons of fixing a home-loan rate.

Interest rates on a number of fixed-rate home loans are currently lower than the variable rates of about 7.4 per cent that are being offered by many lenders. With the prospect that interest rates will go higher over the next 18 months, the question of whether to fix all or some of the borrowing should be accorded serious consideration. With signs of mortgage stress growing, borrowers need to make sure they are taking every opportunity to manage their debt burden efficiently.

Right now the best opportunity may lie in taking advantage of highly competitive fixed rates.

The financial services analyst for Infochoice, David Lalich, says most of the changes are to two- and three-year rates. The best two-year fixed rates are below 7.2 per cent, which is competitive with a number of lenders' variable rates. The most competitive are RAMS, the Bank of Queensland, HSBC, Nationwide Mortgage and Commonwealth Bank.

Borrowers can have three-year rates below 7.5 per cent from RAMS, Heritage Building Society, Westpac, National Australia Bank, Better Option Home Loans and Greater Building Society. Fixed-rate loans usually cost more than variable rates because the borrower is paying a premium for certainty. It is like an insurance policy, whereby the borrower pays the bank for taking over the interest rate risk. At the moment, that premium is very low, which reduces the chances of becoming locked into a rate that could very well become unattractive a couple of years down the track. Part of the fixed-or-variable debate has to be a consideration of where interest rates are headed.

The Reserve Bank's decision to hold off on a rate rise this month, combined with concerns that the European sovereign debt crisis is the beginning of GFC II, might lead people to think that the Reserve has taken further rate increases off its agenda. Bank economists say it would be a mistake to think that way. All of them are forecasting higher rates later this year and throughout 2011.

ANZ forecasts that the official cash rate will rise from its current level of 4.5 per cent to 4.75 per cent in the September quarter and then to 5 per cent by the end of the year. It expects the Reserve to have pushed cash rates to 5.5 per cent by June next year. Westpac's latest forecast is for the cash rate to hit 5 per cent by the end of the year and to reach 5.5 per cent by September next year.

The Commonwealth Bank is more bearish. It expects the cash rate to be 5 per cent by the end of the year and 6 per cent by the end of 2011. Its view is that the strength of the Asian economy is the real determining factor for Australian monetary policy, not what is happening in Europe.

The National Australia Bank has a similar view. It is forecasting a cash rate of 5.25 per cent by the end of the year and 6 per cent by the end of 2011.

Its latest commentary says: "The key driver of our upward forecast is the additional income generated by sharply higher forecasts for the terms of trade - up 18 per cent over 2010. That, in turn, flows over into additional investment, profits and consumption."

Mortgage market data from a number of sources over the past couple of weeks shows an increase in the take-up of fixed-rate home loans. Such loans made up 3.26 per cent of the Mortgage Choice approvals in May, compared with 1.77 per cent in April.

The Australian Bureau of Statistics' housing finance data shows fixed-rate loans dropped from a peak of 8 per cent of all dwellings financed in June last year to a low of 2.1 per cent in February and March. There was a pick-up to 2.4 per cent in April.

The head of macro markets at AMP Capital Investors, Simon Warner, says fixed-rate loans are at attractive levels: "Some of them are lower now than when the Reserve Bank started putting rates up last year. This is definitely an opportunity for borrowers," he says. "It is hard to see them going any lower than they are now. Some big economic issue would have to come into play for that to happen. If I were a risk-averse borrower, I would be locking in." Most borrowers do take a risk-averse approach to their borrowings.

The deputy governor of the Reserve Bank, Ric Battellino, said in a speech in Sydney this month that half of all home loan borrowers have been ahead of schedule on loan repayments in recent months. He says the current arrears rate on home loans is 0.7 per cent, which has increased over the past couple of years but is one of the lowest levels of non-performing loans among the developed economies.

However, there is also plenty of evidence that borrowers are getting into trouble.

Westpac reported in May that the number of mortgage customers in its hardship assistance program (people who have approached the bank to have their repayment terms varied because they are in financial difficulty) had doubled since September.

According to the most recent Fujitsu Consulting Mortgage Stress-O-Meter, released in March, the number of severely stressed households (those facing a forced sale) has risen this year as a result of higher interest rates. Borrowers tend to shy away from fixed rates for several reasons. They are inflexible, providing no opportunity for additional repayments, offsets or redraws. Borrowers risk being locked into a rate that ends up being higher than the variable rate if rates start to fall; and if borrowers want to get out of a fixed-rate loan they are required to pay high break costs. Break fees are set as a percentage of the loan amount or several months' interest payments. Whichever way they are calculated, they can cost thousands of dollars.

The Reserve has reported that bank-fee income on home loans increased by 17 per cent last year. In its report on fees, the Reserve says: "The available information suggests that break fees on fixed-rate loans accounted for a significant proportion of the overall growth in fees."