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Is Fixing The Answer?

With interest rate rises in 2007, some borrowers are looking nervously at their increasing mortgage repayments and asking – is fixing the interest rate a good idea?

Traditionally, Australians have always favoured the variable rate home loan. It was reported recently that some 80% of all home loans carry a variable interest rate. Interestingly, the USA and New Zealand are the reverse, where 80% of all current home loans are wholly or partly set with a fixed interest rate.

Whenever variable interest rates increase, however, borrowers understandably review their options. Therefore there is a trend towards fixed rate home loans, with some lenders reporting up to 25% of new loans being either a fixed or split loan.

So what are the main features of a fixed rate home loan?

Features

The most obvious feature is that the interest rate is fixed for a set period, typically between one and five years. At the end of this period the loan will normally revert to the standard variable rate product of the lender, although you can usually renegotiate a further term at the interest rates in force at that time.

Traditionally fixed rate loans have had fewer features than variable rated products. For example, they may not allow for extra repayments to be made. Also, to get out of a fixed rate loan before the end of the contract period is sometimes very expensive.

More recently, though, some lenders are making their fixed rate products more flexible. For example, in the past few years we've seen the expansion of split or combination loans. This is where a proportion of the loan is fixed, whilst the remainder is left as variable.

Benefits

The main benefit of a fixed rate home loan is **certainty** – the amount of the regular repayment will not vary for the period that the loan is fixed. For some people this is extremely important, and acts as an insurance policy or hedging against further variable rate increases.

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For example, **first home buyers** or **couples starting a family** tend to be on a tight budget. Knowing that the repayments won't go up for the next few years can provide peace of mind.

Also, people may be concerned about potential changes to their job or income level, and so would welcome the certainty of the repayment amount.

Similarly, **property investors** may also be seeking certainty on the costs of their investment. By locking in the interest rate and having a fixed rental amount coming in from the property means that much of the cash flow is predictable.

For some, they may believe that variable rates will continue to increase in the future, and so are prepared to *"bet"* against this by fixing their rate.

Future Direction

However, unless you are an expert in money markets and the future direction of inflation and the economy, it is impossible to predict where interest rates will go. By fixing your interest rate you could therefore be locking into a rate higher than the average variable rate over the period that you've fixed for.

For this reason, many borrowers choose to fix for less than three years. Then, if variable rates do fall, they are only locked in to paying a higher rate for a fairly short period.

Split Loans

Another way to *"hedge your bets"* is to consider a split or combination loan. This product allows you to have a fixed interest rate for a proportion of the amount borrowed, and a variable rate for the rest. The split between the two is decided at the outset of the loan. Typically these splits are 50% to 70% fixed, with the remainder left as variable.

The benefit of this type of loan is that you get some of the advantages of each type of loan. You can have the flexible features of a variable rate loan and enjoy the lower cost when interest rates fall, whilst still fixing the interest rate on part of the loan as a hedge against increasing interest rates.

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Wide Variations

There are well over 100 fixed rate products on the market and, as you'd expect, wide variations in interest rates and features. For example, on a three year fixed rate home loan the interest rate *"spread"* is over 1%, which can make a significant difference to the repayments. Also the range and flexibility of the loan features, and the size of the exit costs, vary greatly.

If you'd like to consider a fixed rate or split loan, then we can help you to compare the different products available. Please feel free to get in touch for a *"no cost, no obligation"* review.

Sources

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