FEATURE ARTICLE: FIXED VS FLOATING

SUMMARY

There has been a notable pickup in media and analyst commentary of late suggesting that now is the right time for homeowners to fix their mortgages. We delve deeper into the issue, weighing up the benefits of fixing, and find that there is no clear-cut answer. It is certainly true that some fixed mortgage rates offer good value – after all, some fixed rates are as low as the floating rate, so unless you think the floating rate is set to fall, why not fix? If only it were that simple! With OCR hikes some way off, and eventual rate rises set to be gradual, borrowers have time on their side. Moreover, we need to be mindful of the impact of fees, and the lack of flexibility that goes with being fixed.

INTRODUCTION

With a host of commentators now telling people it's the right time to fix their mortgage, we thought it's time for us to wade into the discussion. We have decided to do so for several reasons. For one, **the decision to fix is not a simple one** – and it is fanciful to suggest that there's one right answer for everyone. Moreover, **it's not good enough to simply say that now's the time to fix just because you think rates are going higher,** as some fixed rates are higher than the floating rate, and thus are "priced" for future rate increases. Second, we need to appreciate **the nuances of the RBNZ's most recent message, which, at face value, suggests the OCR is set to remain at 2.5 percent for a while,** with only 100bps of OCR hikes signalled over the next 3 years. We also need to appreciate that **there are risks to the outlook** – some sort of recovery looks to be in prospect, but it could yet be derailed. And finally, **we need to be cognisant of the impact of discounts, fees, and other aspects like inflexibility** that go with fixing.

CONSIDERATIONS

Broadly speaking, **we believe there are four main considerations that matter for borrowers mulling the decision to fix,** remain floating, or some combination of the two. They are likely to be:

- First and foremost, **your personal circumstances**. How much certainty do you need? Do you plan on selling your house, upsizing, or making early repayments?
- **Cost.** For many people the decision to fix is based solely on price – the lowest mortgage rate is the best rate, irrespective of term. This is not necessarily a bad strategy, and some people have done well following this approach. But we think there is some value to be had in crunching the numbers – using breakeven analysis and the like, and using that to make a more informed decision. Let's also not lose sight of the cost of being wrong. For example, there has been a lot of focus on the cost of not being fixed if rates move up, but what about the decision to fix if the economic outlook worsens?
- **Fees and discounts** also matter, as they can tilt the playing field, so to speak.
- Finally, consider the **benefits of swimming with the tide.** Indeed, the more borrowing that is on floating, the more "punch" monetary policy packs, and hence the less active the RBNZ needs to be.

YOUR PERSONAL CIRCUMSTANCES MATTER

The decision to fix or float is not black and white. It's not solely about the cash benefits, and will depend on your personal circumstances at a point in time. As such, it may be sensible to think about what you intend on doing over the next few years before fixing. **Good questions to ask are: do you intend to move house, upsize, downsize, or make lump sum repayments?** If you do, it may not be sensible to be 100 percent fixed. Other personal factors influence the decision to fix or float. These include characteristics like your risk appetite, how much certainty you need, and whether you can afford to take the risk that interest rates increase. If those are all concerns, then you may be more inclined to fix. Everyone's personal circumstances are different, and if you have concerns or are muddling through options, we suggest talking to a financial advisor or someone at the bank. If the issue of where interest rates might go keeps you awake at night, then do something about it!

The reality is that there is no right answer. Fixing provides you with cash flow certainty, but often comes at a cost. For example, at the moment, fixing for 3-5 years costs more than floating or fixing for between 6 months and 2 years. Fixing can also be expensive if, for example, you need to sell your house and break your mortgage. **On the other hand, floating gives you flexibility,** is often cheaper, allows you to wait for a better fixed rate should one come up, and gives you the flexibility to make larger lump sum repayments.

In practice we think there is merit in splitting your mortgage into 3-4 tranches, and then choosing a mixture of fixed and floating that offers you a suitable mix of flexibility and certainty. Such a strategy also means you are likely to avoid getting exposed to "rate shock", which is the risk that when your fixed term rolls off, interest rates have increased dramatically (though this sometimes

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also works the other way). By selecting a combination of fixed and floating you can smooth your interest expense. This is important, because the reality is, over the long term, you won't be able to get your timing right in every decision.

BEWARE THE LOSE/LOSE COMBINATION

When making the decision to fix or float, it's also important to take into consideration prospects for the economy. In the current instance, this is framed as: the economy will improve, mortgage interest rates will move up, so you should be taking some fixed rate certainty. Unfortunately, the outlook is never so certain.

Broadly speaking, mortgage interest rates will move in line with the economy (up and down) and borrowers have the choice of fixing or floating, which gives four possible scenarios.

If the economy is strong (rising house prices, stronger labour market) and you lock in at an attractive rate, which is akin to beating the market; you win on both counts.

If you win on the economy but lose on the floating rate (it moves up), you'll be grumpy, but it's probably an "affordable" trade to make. If the economy weakens but you stay on a floating rate, you will at least gain from lower borrowing costs.

You want to avoid the lose/lose quadrant where you are locked into a fixed rate mortgage, just before the economy takes a turn for the worse, the labour market deteriorates, and house prices come under downward pressure.

The key is to recognise all options and look at them in regard to your own personal circumstances.

Term/Outlook	Lock in Mortgage	Floating Mortgage
Economy Up	**Win/Win** Better labour market, stronger housing market. Rates don't move.	**Win/Lose** Better labour and housing market. But floating rates move up.
Economy Down	**Lose/Lose** Economy worse and you're not benefitting from lower rates.	**Lose/Win** Weaker economy but you gain from falls in borrowing costs.

WE'VE BEEN HERE BEFORE

We've lost count of how many times unnamed economists have pulled out the same arguments highlighting that the OCR is headed up, the wedge between fixed and floating rates is low (so the former is "cheap") so fixed rate borrowing is appealing. Three years on since the global financial crisis, it is worth bearing in mind that the floating rate has by far and away been the most attractive. This does not mean this will continue, but we are drawn to the historical evidence that shows the average recovery time following a financial crisis has been 7 years, which is later than typical cyclical recoveries.

THE ECONOMIC OUTLOOK: OUR VIEW

The economic outlook continues to be dominated by the complex interaction of significant shocks. We are facing a deleveraging imperative, the need to balance the books (earn more and spend less), global wobbles, an income shock, and the consequences of a natural disaster. **Given this combination it is only natural to see mixed economic signals.**

As structural and cyclical forces clash, we envisage a period of ongoing volatility and a lower rate of trend growth. We would characterise the outlook to be one of "grumpy growth", with the cyclical recovery tempered by structural headwinds as households focus on repairing balance sheets. A key assumption here is that we are witnessing a structural change in behaviour. A period of deleveraging should continue to delay and temper any significant recovery in household spending and potential for housing to truly lead the economic recovery. People are choosing to live within their means, and this applies equally to the size of their home and mortgage.

This lower rate of trend growth and relatively benign inflation outlook is likely to see interest rates stay lower for longer. Indeed, the RBNZ is projecting the OCR to rise to only 3.5 percent in the coming three years while we are forecasting an endpoint of around 4 percent.

If this seems incredibly low to some, and it is relative to history, consider Australia – the so called lucky country, where the Cash Rate peaked at 4.75 percent and is now at 4.25 percent.

LOOKING AT THE BREAKEVENS

An economic view that interest rates will eventually move up is insufficient reason to take the fixed lending option. **You need to look at the breakevens, crunch the numbers, and see how things stack up.**

Breakeven analysis is useful for highlighting the tradeoffs between different fixed-rate terms. By analysing where rates need to be in the future (the breakeven rate), and comparing them to expectations or forecasts, **we can make a more informed decision.**

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Mortgage Rates		Breakevens			
Term	Current	In 6 mths	In 1yr	In 18 mths	In 2 yrs
Floating	5.74%				
6 months	5.65%	5.65%	6.37%	5.49%	6.57%
1 year	5.65%	6.01%	5.93%	6.03%	6.72%
2 years	5.79%	6.02%	6.33%	6.61%	7.21%
3 years	6.10%	6.41%	6.78%	7.11%	7.64%
4 years	6.50%	6.83%	7.21%		
5 years	6.90%				

As an example, let's say you considering fixing for 3 years because you are worried interest rates might rise. There are several things you could do. The most obvious would be to fix for 3 years. But it's not your only choice. You could, for example, fix for 1 year, and then fix for a further 2 years in 1 year. The question is: where does the new 2 year rate need to be in 1 year's time for the latter "split" strategy to be the better one? This is the breakeven rate, and as the table above shows, the answer is 6.33 percent. That is, if you fix for 1 year today, so long as you can fix for 2 years in 1 year below 6.33 percent, then you'll be better off doing that than just fixing today for 3 years at 6.10 percent. The question then becomes, with the 2 year rate now at 5.79 percent, do you expect that to move up beyond 6.33 percent in the next year? It could, but it's a line call when we compare it to our forecast.

Breakevens (including the example we just went through) also demonstrate that **the market is already "pricing in" higher rates over time, reinforcing our earlier point that it's not good enough to say now is a good time to fix because you think rates are heading higher.** Instead, what you need to do is figure out how high, and that's why we like breakeven analysis.

What we also know from breakevens (which is one consideration in deciding on what to do) is that the premium to fix out to 2-3 years is small. We like the savings that floating offers, but when we consider breakevens and certainty, there is certainly some value to be had in being fixed for potentially up to 2 years. Breakevens don't seem to justify anything beyond that.

DISCOUNTS AND FEES MAKE A DIFFERENCE

Many borrowers may find they are able to negotiate discounts. **The important thing for borrowers is to remember to compare apples with apples, so to speak, and use discounted rates in their analysis,** rather than just looking at specials and carded rates.

Fees can also make a huge difference. The choice between fixed and floating is not always black and white, but rather many shades of grey. In the case of moving on to a fixed rate, borrowers must be aware of the hidden costs. As an example, a lock fee of say $250 represents 0.4 percent on a $125,000 mortgage over 6 months, or 0.1 percent on a $125,000 mortgage over two years. These costs need to be added to the fixed rate for the purpose of comparability and breakeven analysis.

Breaking a fixed rate mortgage contract can also be an expensive proposition. Recall in 2008 and 2009 when the RBNZ cut its OCR from 8.25 percent to 2.5 percent. Those locked into double digit 5-year fixed rates were forced to pay significant break fees in order to move onto much lower floating rates.

OFFSHORE BORROWING COSTS – THE REAL STORY

The argument running around at the moment is that courtesy of European situation, the cost of international borrowing is expensive, therefore **banks cost of funds is rising,** and borrowing rates will move up. **This is true to some extent, but we need to acknowledge wider considerations.**

- **Offshore borrowing costs have actually eased** over the past few weeks – consider this the marginal cost of funds.
- **The level of offshore borrowing costs is still expensive** and this is slowly raising banks' average cost of funds. Or more aptly, while borrowing costs are cheaper than a few weeks ago, they are still higher than last year.
- **The speed of feed-through into NZ banks' average cost of funds has been slowed** by low credit growth and NZ banks having considerable term funding in place. Growth in domestic deposits also limits the need for offshore funding.
- Nonetheless, the average cost of funds is rising and if unchecked, this could see borrowing rates move up.
- **But financial markets (and the RBNZ) implicitly recognise this.** Wholesale interest rates fell when funding costs were extreme and have eased when markets have improved. These changes have largely been offsetting. In its March *Monetary Policy Statement* the RBNZ assumed that rising funding costs contributed to a 30bps tightening in financial conditions from the previous quarter, one of the reasons they don't expect to lift the OCR as far.

ANZ

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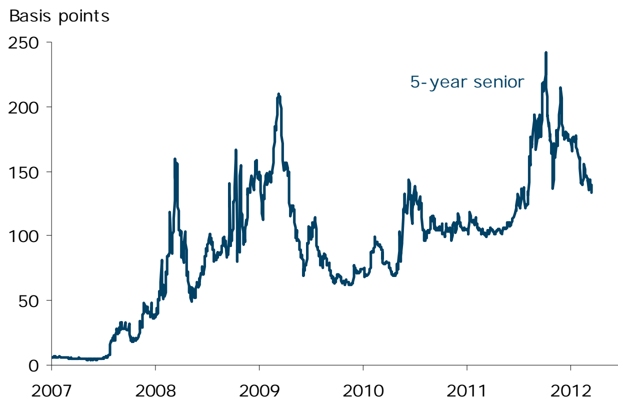
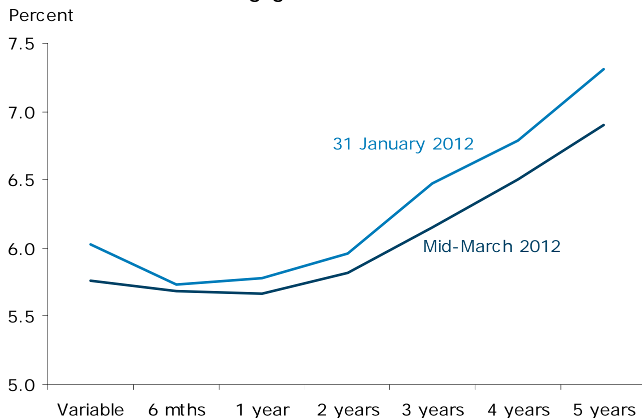


Sources: ANZ, National Bank, Bloomberg

The chart above shows credit spreads for the big 4 Australian banks have fallen by more than 0.50 percent since the height of the European sovereign debt crisis in late 2011. So the change is down but the level is still high.



Sources: ANZ, National Bank, www.interest.co.nz

SOOTHING WORDS FROM THE RBNZ

Reserve Bank projections for the 90-day interest rate in the March *MPS* were benign. The Bank is projecting the OCR to peak at around 3.5 percent in early 2015.

We believe the RBNZ is probably undershooting reality here, but agree with the spirit of what they are saying, which is simply that the OCR is not moving up fast or too high.

It is worth noting that Governor Bollard has also commented that a "further rate cut was completely a possibility", but that the Bank was not looking into this "at the minute". While we attach a very low probability to a further cut in the OCR, the risk remains that the OCR and floating mortgage rates could remain lower for longer – another consideration for those considering fixing their mortgage. Should the RBNZ's interest rate track come to fruition, floating rates could rise from 5.7 percent to around 6.6 percent over the next 3 years (with an average of 6.1 percent). Coincidentally, that corresponds to the current 3 year rate of around 6.1 percent. If you take the RBNZ at face value, then there may be little gain to be had from fixing. That said, as we discuss in the next paragraph, it is simplistic to assume that mortgage rates will move exactly in tandem with the OCR over the next three years.

CRUNCHING THE NUMBERS

Beware of simple analysis that projects the floating mortgage rate going to 8 percent plus. Such projections are premised off assumptions the OCR will head back towards 5 percent (still low) and if you add the current gap between mortgage rates and the OCR you get a floating mortgage rate of in excess of 8 percent.

Such analysis is too clever by half. If current credit dislocation and the aftermath of the financial crisis means the gap between floating mortgage rate and the OCR is 300 basis points, the OCR will not be moving up to 5 percent. End of story.

THERE IS MORE THAN ONE WAY TO SKIN A CAT

Monetary policy needs friends. The OCR is a blunt instrument. There is much talk about the unintended consequences of housing booms and the impact the "solution" in the form of higher interest rates has on the tradable sector in particular. There is heightened sensitivity on this at present, and while the RBNZ now have the capacity to intervene in FX markets, this is only done under certain criteria. In addition to FX intervention, the RBNZ have investigated other ancillary policy instruments.

What we know at present is that:

- **Ancillary instruments have been used in the past.** These include widening repo collateral eligibility, Term Auction Facilities, USD swap facilities, and tweaks to prudential policy, as the next point notes. The key point here is that the RBNZ has other levers it can pull to alleviate an unhelpful build-up of pressures (such as funding pressures) if it needs to.

- **Prudential policy changes** such as those pertaining to the core funding ratio (CFR) fundamentally alter the lending equation for banks. Retail and long term lenders need to be paid a premium to part with their funds. The flip side of this is that borrowers should expect to pay a term premium too. Regimes like the CFR won't eliminate the possibility of a boom, though they heavily mitigate the potential.

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- **The RBNZ has put some ideas on the table** which they think could help, but with no take-up. For example, in the Bank's 2007 submission to the Government's Finance and Expenditure Select Committee, they noted that they had examined the possibility of using "additional tools or policy approaches" to supplement monetary policy. Their conclusion was that some of the tools proposed would be "difficult to use" and were likely to "cause collateral damage". Broadly speaking, these tools tended to be of the micro variety. However, the Bank did note that there were other areas that warranted further consideration. Among other things, these included tax changes (to remove the bias towards housing), curbs on government spending at times when domestic demand was already strong, removing regulatory restrictions to ease land shortages, and managing inward migration so as to not exacerbate economic cycles. Let's also not forget that one major political party is now advocating a capital gains tax.

- **Monetary policy and fiscal policy are far more co-ordinated now than they ever used to be.** With more belt-tightening in store fiscal-wise, interest rates are likely to be lower for longer.

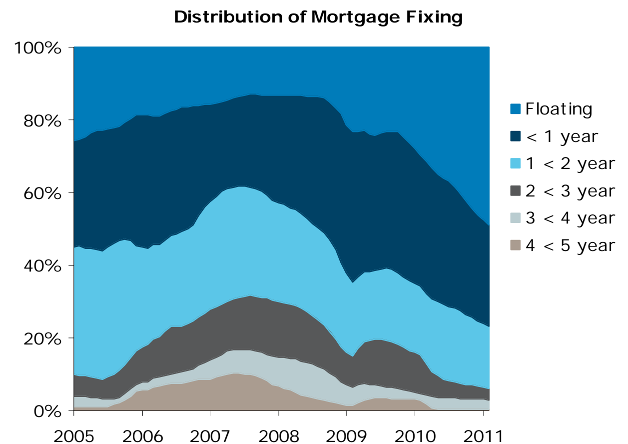
Such regulatory tools are not a panacea, nor will they ever replace the Official Cash Rate as the RBNZ's primary policy instrument. But we need to acknowledge them if we are to have an informed view of what's in store for monetary policy. We also have to acknowledge that much work is going on in the background. Policy developments so far (like the CFR) have tended to come from the prudential side of the equation – i.e. setting broad policies to encourage banks to rejig their balance sheets. But if such measures aren't enough, it is not unreasonable to expect "micro" responses, such as limiting LVRs, to be introduced, as the Bank of Canada did after the GFC.

We also need to recognise that banks' own policy tweaks in loan-to-value ratios, such as what is going on now, can work in the other direction, so it's far from one-way traffic. At the regional authority level you can foresee changes in land availability as local governments play their part in easing New Zealand's structural housing shortage.

Such forces complicate the picture facing policymakers. What we know is that lax prudential oversight was one reason behind the global financial crisis. The regulatory breeze is now blowing stronger. Debate will surround what is an appropriate breeze. But one thing is certain: its not going away.

SWIMMING WITH THE TIDE?

The shape or slope of the mortgage curve also matters. New Zealand borrowers have benefitted from an inverted yield curve and relatively lower fixed mortgage interest rates on a number of occasions in our recent history. In a way, this has been ingrained into our collective psyche, and may cause us to jump too quickly back into fixed. By contrast, when we look at how behaviours have changed over the past 2 years, we note that a much larger proportion of borrowers are now on a floating rate mortgages. As the chart below shows, nearly 85 percent of borrowing is now on either floating or on a fixed rate with less than 1 year to go. This in turn, makes borrowers more exposed to RBNZ decisions, which means the RBNZ will hike less aggressively in future, when the time comes to lift the OCR. **This "partnership" between the RBNZ and borrowers may be beneficial to both parties.**



Sources: ANZ, National Bank, RBNZ

It is useful to examine the experience of Australia over the past decade. Most borrowers are floating. Interest rates have been tweaked now and again, and what has happened has been two-fold. First, they've had to be tweaked less often and second, they haven't gone up as far.

OUR ACHILLES' HEEL

We're presenting the "hope all goes well scenario" which is heavily premised on voluntary structural deleveraging continuing. This means the housing market does not get up an excessive head of steam.

There is also an involuntary scenario that involves the forced realignment of monetary conditions – a lower currency and higher interest rates – the endgame if New Zealand's borrow and spend habits have not been curbed. This remains a risk, though we'll put that one aside for now.

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THE UPSHOT

We are in a rising interest rate environment – that much seems reasonably (but not completely) certain. But by the same token, the RBNZ does not expect to need to increase the OCR up until much later in the year. And with so many borrowers on floating, they won't need to do much to make an impact.

On its own, expecting interest rates to rise is a good reason to contemplate fixing. But it is not a good enough reason in itself to actually do so. Instead, it makes sense to **crunch the numbers,** whereupon you are likely to conclude that the 6 month, 1 year and 2 year rates offer the best breakevens.

However, most analysis and commentary focuses too much on the simple spread between the fixed and floating rate. To say there are wider considerations is an understatement. **No hard and fast rules exist.** Much depends on individuals' personal circumstances. **The key is to take account of the broader picture before making a final decision.**

KEY FORECASTS

Weekly mortgage repayments table (based on 25-year term)

	Mortgage Rate (%)													
Mortgage Size ($'000)	5.00	5.25	5.50	5.75	6.00	6.25	6.50	6.75	7.00	7.25	7.50	7.75	8.00	8.25
200	270	276	283	290	297	304	311	319	326	333	341	348	356	364
250	337	345	354	363	371	380	389	398	407	417	426	435	445	455
300	404	415	425	435	446	456	467	478	489	500	511	522	534	545
350	472	484	496	508	520	532	545	558	570	583	596	610	623	636
400	539	553	566	580	594	608	623	637	652	667	682	697	712	727
450	607	622	637	653	669	684	701	717	733	750	767	784	801	818
500	674	691	708	725	743	761	778	797	815	833	852	871	890	909
550	741	760	779	798	817	837	856	876	896	917	937	958	979	1,000
600	809	829	850	870	891	913	934	956	978	1,000	1,022	1,045	1,068	1,091
650	876	898	920	943	966	989	1,012	1,036	1,059	1,083	1,108	1,132	1,157	1,182
700	944	967	991	1,015	1,040	1,065	1,090	1,115	1,141	1,167	1,193	1,219	1,246	1,273
750	1,011	1,036	1,062	1,088	1,114	1,141	1,168	1,195	1,222	1,250	1,278	1,306	1,335	1,364
800	1,078	1,105	1,133	1,160	1,188	1,217	1,246	1,274	1,304	1,333	1,363	1,393	1,424	1,454
850	1,146	1,174	1,204	1,233	1,263	1,293	1,323	1,354	1,385	1,417	1,448	1,480	1,513	1,545
900	1,213	1,244	1,274	1,306	1,337	1,369	1,401	1,434	1,467	1,500	1,534	1,567	1,602	1,636
950	1,281	1,313	1,345	1,378	1,411	1,445	1,479	1,513	1,548	1,583	1,619	1,655	1,691	1,727
1000	1,348	1,382	1,416	1,451	1,486	1,521	1,557	1,593	1,630	1,667	1,704	1,742	1,780	1,818

Housing market indicators for February 2012 (based on REINZ data)

	House prices (ann % change)	3mth % chng	No of sales (s.a.)	Mthly % chng	Avg days to sell (s.a)	Comment
Northland	-3.3	1.0	119	(-10%)	60	Largest drop in the number of sales, lowest in 5 months
Auckland	0.6	0.7	2,281	(+7%)	32	Number of sales highest monthly figure since August 2007
Waikato/BOP/Gisborne	2.1	0.5	885	(+4%)	53	Strongest volume of house sales since September 2009
Hawke's Bay	0.6	-0.3	190	(-1%)	54	Volume of sales remains high – 2nd highest since Nov-09
Taranaki	-4.9	0.9	266	(+6%)	49	Median sales price weakened slightly from a month earlier
Manawatu-Whanganui	-4.5	3.2	182	(+17%)	55	Annual price growth slipped below nationwide average
Wellington	-5.2	0.4	648	(+5%)	39	Strongest number of sales since November 2009
Nelson-Marlborough	0.0	-1.7	270	(+22%)	36	The median days to sell dropped to a 26-month low
Canterbury/Westland	14.2	1.5	858	(+10%)	28	Median sales price hit a new record high of $335,000
Central Otago Lakes	-9.0	5.2	107	(+16%)	62	Monthly number of sales above 100, for first since Sep-09
Otago	1.7	2.1	225	(-1%)	36	Median sale price, at $241k, lifted to highest in 15 months
Southland	-13.2	-0.2	186	(+68%)	46	Largest fall in sale prices compared to a year ago
NEW ZEALAND	1.4	0.7	6,291	(+8%)	39	Regional differences – led by Auckland and Canterbury

Key forecasts

	Actual			Forecast						
Economic indicators	Jun-11	Sep-11	Dec-11	Mar-12	Jun-12	Sep-12	Dec-12	Mar-13	Jun-13	Sep-13
GDP (Ann Avg % Chg)	1.1	1.3	1.6(f)	1.7	1.9	1.9	1.9	2.1	2.4	2.8
CPI Inflation (%)	5.3	4.6	1.8	1.6	1.2	1.6	2.3	2.4	2.4	2.5
Unemployment Rate (%)	6.6	6.6	6.3	6.4	6.3	6.3	6.3	6.3	6.2	6.1

	Actual			Forecast (end month)						
Interest rates	Jan-12	Feb-12	Latest	Jun-12	Sep-12	Dec-12	Mar-13	Jun-13	Sep-13	Dec-13
Official Cash Rate	2.50	2.50	2.50	2.50	2.50	2.75	3.25	3.25	3.50	4.00
90-Day Bank Bill Rate	2.7	2.7	2.7	2.8	2.8	3.2	3.5	3.5	3.9	4.3
Floating Mortgage Rate	5.9	5.9	5.9	5.7	5.7	6.0	6.4	6.4	6.6	7.1
1-Yr Fixed Mortgage Rate	5.7	5.7	5.6	5.9	5.9	6.2	6.4	6.4	6.8	7.0
2-Yr Fixed Mortgage Rate	5.9	5.8	5.8	5.9	6.1	6.3	6.5	6.6	6.9	7.1
5-Yr Fixed Mortgage Rate	7.2	7.0	6.9	7.0	7.0	7.0	7.1	7.0	7.1	7.2

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