

Which Way?

Fixed or variable: Which is better for you in the new-look mortgage market?

We are living in a new era of home mortgage rates and some of the basics have changed. If you are currently paying off a mortgage or planning to buy a home in the near future, it is very important to understand the new pros and cons of the choice between a fixed rate and variable rate home loan.

If you choose to fix your interest rate, you will agree to freeze your mortgage at a fixed rate which is higher than the current variable rate for a certain number of years - say 10% a year for 5 years.

If interest rates rise above 10% over the next 5 years you save money and if they fall below 10%, you pay more than you may have had to.

On the other hand, if you choose a variable rate, you'll pay less while mortgage rates stay below 10%, and pay more if they go higher.

Since the Australian Reserve Bank uses interest rate rises to discourage spending and curb inflation, interest rates – including mortgage interest rates have traditionally tended to go up when inflation rates are higher and go down when inflation rates improve.

Unfortunately, one side effect of last year's collapse of the third tier bond market in the USA has been to sweep aside the direct connection between inflation and interest rates. For the first time ever, Australian banks are raising interest rates on mortgages on their own initiative, regardless of whether the Reserve Bank actually increases interest rates or not and irrespective of the inflation rate.

Why is this happening? It's because for banks, the cost of borrowing funds to lend out as mortgages has increased. This is due to a tight international money market which results in banks having to pay higher interest rates themselves. As banks are publicly owned companies with shareholders, they are choosing to pass that increased cost on to their customers.



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What makes the fixed vs. variable question a difficult one to answer, is that nobody really knows what will happen to interest rates or the money supply over the next few years. You can't fix a rate forever so whether it is better to switch from a variable to a fixed interest mortgage at this moment depends mainly on how you feel about where interest rates and the international money supply are heading. Another factor to consider is the flexibility of your family budget.

If you have enough slack in your income to accommodate interest rate rises, you may wish to grit your teeth and sit out this period of rate uncertainty in the hope that rates will drop again before too long.

Alternatively, if you are on a tight budget it may be easier for you to plan and budget when the mortgage repayment is known and frozen for the next few years.

Having a bet each way is another possibility. You can fix for a short term, say 2 years, keeping your options open after that. Or, you can freeze part of your mortgage while the balance remains variable, aiming for average mortgage repayments that are lower than the fixed rate.

You should never forget however, that interest rates are not always the most important factor in the cost of a mortgage – the ability to pay the mortgage off faster can actually save you a lot more than what you pay in interest rate rises.