ASB

Home Loan Rate Report

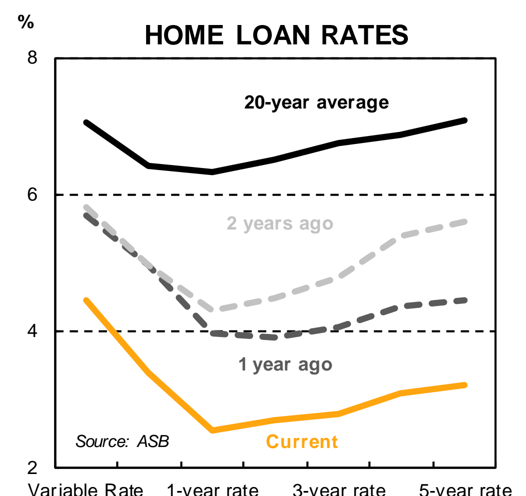
31 August 2020

Mortgage rates could press even lower

- The RBNZ's massive response to the COVID-19 situation has seen mortgages press lower over recent months.
- Borrowers can lock in record low interest rates now, with fixed term rates as low as 2.55%.
- Our forecasts suggest rates could get even lower over the year ahead. Fixing and then rolling shorter term mortgages terms is forecast to be the cheapest option over a 5-year time horizon.
- Mortgage interest rates look set to stay extremely low over the next several years. Nonetheless, borrowers are prudent to plan to deal with higher interest rate costs over the long run, rather than budget on rates remaining this low indefinitely.

A dramatic change in circumstances over 2020

At the start of the year ASB economists thought the Reserve Bank (RBNZ) would keep the Official Cash Rate (OCR) on hold at 1% this year and into 2021. Back then we also thought that mortgage rates could be at a low point and would start to rise over the coming years. That view has changed dramatically because of COVID-19.



The outlook for the economy and in turn interest rates changed over February and March as the coronavirus turned into a global pandemic. In March the RBNZ and other central banks slashed their respective policy rates to record low levels and instigated other support measures to provide liquidity and drive long-term yields lower. Mortgage interest rates have dropped significantly in the wake of the RBNZ's actions. Furthermore, the RBNZ has (temporarily) removed the loan to value ratio (LVR) restrictions that were impacting borrowers and borrowing costs. And more recently, ASB has simplified things for borrowers by offering only one table of carded rates, rather than two tiers (for high and low LVR loans), as had become the norm in the LVR era. We expect the RBNZ to maintain downward pressure on mortgage rates over the year ahead, by cutting the OCR into negative territory and introducing other policies to lower borrowing costs.

What's driving mortgage rates these days?

Mortgage interest rates are influenced by a range of factors, including the RBNZ's OCR setting, developments in domestic and global fixed-interest markets, and other influences on bank funding costs. This year we add "quantitative easing" into the mix of things the RBNZ is doing that indirectly impact mortgages. Basically, quantitative easing means the RBNZ is exerting influence on a wider range of interest rates in the economy, by buying bonds and

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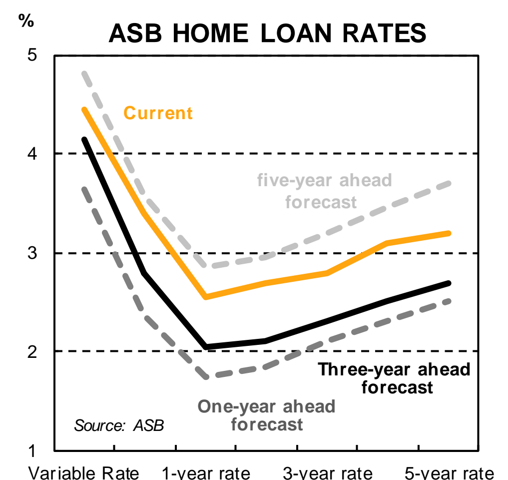
boosting liquidity as well as setting the Official Cash Rate.

At this stage it would be useful to recap on what has happened over the last 12 months or so. In mid-2019, the 0.75% of OCR cuts by the RBNZ and the weakening global interest rate backdrop had pushed mortgage rates to very low levels by Spring 2019. Mortgage interest rates over various tenors had fallen between 0.6% and 1.2% over a period of around 18 months, but barely budged between November and February 2020. On 12 February the RBNZ maintained the 1% OCR setting, and was optimistic about the economy's prospects.

But all that changed considerably over the following weeks as the seriousness of the COVID-19 pandemic became apparent. The RBNZ joined offshore central banks and eased interest rates significantly in March, cutting the OCR by 75bp to 0.25% on 16 March and committed to keep the OCR at this level for at least 12 months. Then on March 23, the RBNZ kick-started its quantitative easing programme, with the unveiling of a Large-Scale Asset Purchase Programme to (mostly) purchase NZ Government bonds. Quantitative easing is all about driving longer-term interest rates in the economy lower and bolstering liquidity, both of which support demand in the economy. Although the RBNZ is buying government bonds, it expects the action to also drive retail interest rates (including mortgage rates) lower, as lower wholesale borrowing costs are passed through to retail customers and its actions provide banks with another source of funding besides term deposits and wholesale funding. That's what has happened over recent months, with mortgage rates and term deposit interest rates dropping.

Where are rates now, and what happens next?

Over the next year we expect the RBNZ will do even more to lower borrowing costs in New Zealand. In August, the RBNZ stated that further easing could come from a negative OCR from early next year (the RBNZ is in "active preparation") that would be linked to a Funding for Lending Programme for banks. When it comes to mortgages, our core scenario is that borrowing costs rates can fall over the year ahead if the RBNZ cuts the OCR to -0.5% and establishes a funding program that allows banks to access long-term funding from the RBNZ at or near the OCR setting. Our note on the RBNZ and our outlook for monetary policy settings can be found here. For people interested in how some of the RBNZ's new policy tools work, our recent analysis is here. The world is quite different to what was we imagined at the start of the year. And in that vein, there is more than the usual amount of uncertainty these days, with many moving parts when it comes to RBNZ policy decisions. All this adds to the challenges of forecasting.



In short, we expect mortgage rates to decline over the year ahead. Our forecasts for lower mortgage rates are conditional on the RBNZ cutting the OCR to -0.5% early next year (as we are forecasting) and introducing a bank funding facility like we have seen across the Tasman. Against this backdrop, retail term deposits, wholesale interest rates and mortgage interest rates would all be expected to decline. **Our forecasts suggest that some fixed term mortgage interest rates could dip below 2% over the year ahead, and all fixed terms should stay below current levels for the next two or three years.** Floating mortgage interest rates are also forecast to decline but will remain significantly higher than fixed-term mortgage interest rates for most tenors. With the relative expense of floating in mind, you always need to do some careful calculations if you think it's worth floating in order to time the right moment to fix.

Could mortgage interest rates move higher? Now that mortgage interest rates have unexpectedly fallen to record lows, it's worth pointing out they can unexpectedly go up too. In short, if the economy recovers much quicker than we currently expect, we'd also expect mortgage interest rates to track higher than our current forecasts. Our forecast of modest interest rate increases in the back half of our five-year forecast horizon is illustrated in the chart above.

What about existing mortgages? Is it worth breaking to re-set at a lower rate?

This is a common question. Break costs are an important consideration, and an understandable frustration in a falling interest rate environment. Many people are surprised at the cost of breaking a mortgage these days. So why are break costs there, and why are they large now?

The simple explanation is because when a mortgage was fixed in the past, the costs of that mortgage are a function of the prevailing interest rates the bank was paying for money at that time, not what they are today. In other words, the cost of the underlying funding the bank acquired for the mortgage (fixed in say 2018) remains relevant in calculating the break cost. With both retail mortgage interest rates and the underlying funding rates falling a long way over a relatively short period of time, break costs are often significant.

Nonetheless, ASB can calculate the break costs of a mortgage daily to help with these decisions. There isn't a shortcut to lower mortgage interest rates without incurring a break cost. But breaking a mortgage and resetting at a lower rate can still be a reasonable strategy for getting interest rate certainty for a longer term at row rates. There are many moving parts in this equation, so take time to talk through the numbers, and the pros and cons – it's not a light decision. A rule of thumb to have in mind is that generally, the bigger the difference between the current mortgage rates and the rate you fixed at in the past, and the longer the term remaining, the bigger the break costs will be. There will be a term deposit or wholesale investor that doesn't want to drop the interest rate they locked in around the time you fixed your mortgage, which is the mirror situation: banks must balance the needs of both savers and borrowers.

Why should borrowers plan for higher interest rates in the long term?

For the next few years, borrowers should be able to access mortgages at very low interest rates. For those that require certainly now, fixed terms are currently available at record low levels (around 2.55%-2.69% for 1 to 2 years). Although it seems like a long way off, we still expect the OCR to increase eventually. We expect the associated higher wholesale and term deposit interest rates to eventually start to push NZ mortgage interest rates higher in two- or three-years' time.

Over the past few years, the RBNZ had proposed a new regime for bank capital requirements which would put upward pressure on mortgage rates. The changes have been delayed as we deal with the current challenges of COVID-19. We expect that the RBNZ will want to very gradually phase in higher capital requirements for banks in the future, and that would lead to increases in bank borrowing costs and mortgages. An earlier-than-expected introduction of these changes could put upward pressure on mortgages earlier than our current forecasts imply.

In sum, we continue to think it is prudent for borrowers carrying debt for longer than the next couple of years to budget on mortgage interest rates being higher than they are now. Lenders will likely do any budget calculations for loan eligibility using interest rates that are noticeably higher than the rates on offer today. However, with all this talk about higher interest rates in a few years' time, borrowers will be pleased to know we still expect mortgage interest rates to eventually settle over the next decade at levels well below long-run averages of the past 20 years. And borrowers can lock in incredibly low long-term interest rates of around 3% now if interest rate certainty over a longer period is of utmost importance.

The RBNZ's loan-to-value ratio (LVR) restrictions are removed until next year

The RBNZ first put its LVR restrictions in place back in 2013, and has tweaked them over the subsequent years. The restrictions were not intended to be permanent, but became an important part of the lending environment over the past seven years. On the 30th April the RBNZ removed LVR restrictions for 12 months. The decision was made to ensure the restrictions don't have an undue impact on borrowers or lenders as part of the mortgage deferral scheme implemented in response to the COVID-19 pandemic. Despite the LVR restrictions being removed, and ASB's move to one carded rate for each borrowing horizon, differing levels of equity and risk will likely have a bearing on credit

availability and overall borrowing costs. **Borrowers should discuss their circumstances with their mortgage providers when deciding what to do with their mortgage.**

Identifying the best strategy

Everyone wants to secure the "best" deal for their mortgage. Working out what strategy is best is easier said than done given the number of influences impacting on mortgage interest rates, and individual borrower's differing requirements for flexibility and certainty. Personal preferences for certainty and flexibility are really important considerations when choosing a mortgage rate, rather than simply opting for the lowest rate.

Historically the mortgage curve has been "tick-shaped", with 1- to 3-year fixed rates lower than both the variable and 5-year rate. It's a very flat tick now, with all fixed rates below the floating rates at present. The lowest rates on offer vary between the main banks, but are generally in the "belly" of the curve – from one to two years. These low rates are nearly 2% below the floating rates, at or near record lows, and available with rates around 2.6%. At the other end of the curve, 5-year rates are 1.25% or more below floating rates, and in the low 3% range now.

Borrowers can currently obtain some certainty and a significantly lower rate by fixing their mortgages. While the future is inherently uncertain, our forecasts for mortage rates suggest fixing at the lowest rates on offer then subsequently rolling short terms (e.g. 1- or 2- year fixed rates) is likely to be the cheapest option over a 5-year time horizon. As discussed above, mortgage interest rates can move lower still, but there is a significant cost of floating (at around 4.45%, nearly 2% above what you can fix at now) in order to pick the bottom in rates. Pick a strategy that suits your own needs for flexability as well as minimising interest rate costs.

Borrowers could also consider splitting the mortgage into different terms to better suit their preferences for interest rate certainty versus retaining flexibility.

The table below summarises some of the advantages and disadvantages of the different mortgage terms typically on offer. Floating and short-term fixed rates tend to suit those who prefer the ability to review their mortgage structures frequently (or those who are due to pay off debt shortly). As fixed terms get longer, they are typically preferred for their interest rate certainty.

Term	Advantages	Disadvantages	Rate*	Short-term bias	Long-term bias
Floating	Below 10-year average. Fix at any time. Additional principal repayments are easy.	All fixed term rates are cheaper.	4.45	↘	↑
6-month fixed	Cheaper than floating rate. Short-term certainty. Can pay down, alter, or re-fix fairly quickly.	Less flexibility than floating. Exposed quickly to any near-term rate increases. All other fixed terms are cheaper.	3.39	↘	↑
1-year fixed	Lowest rate currently. Short-term certainty. Can re-fix fairly quickly.	Less protection from near-term interest rate increases.	2.55	↘	↑
18-month fixed	2nd cheapest rate on offer.	Less of a hedge against interest rate increases if rates go up more than expected over the next few years.	2.65	↘	↑
2-year fixed	Provides interest rate certainty for a reasonable period.	Less of a hedge against interest rate increases if rates go up more than expected over the next few years.	2.69	↘	↑
3-year fixed	Certainty for a relatively low cost. Protection if rates rise quicker than expected.	Potentially more expensive than rolling shorter terms.	2.79	↘	↑
5-year fixed	Certainty at a historically low cost for a long time.	Fixing for short terms expected to be cheaper over next 5 years.	3.19	↘	↑

*** ASB carded rate at time of publishing**

Final thoughts for borrowers

Just remember, **the 'best' mortgage rate is only known in hindsight.** But, with the above pros and cons for the various mortgage rates on offer we hope to give you a good platform from which to consider the interest rate options that appear most suitable for your personal circumstances.

On top of trying to minimise your interest payments, a good mortgage strategy also needs to take into your personal cash flows, tolerance for uncertainty, and your ability to deal with changes in future mortgage payments as interest rates change. Every borrower's financial circumstances can change, and you need to take this into account too.

Overall, it is important to weigh up your own priorities and make the mortgage choice that looks best aligned with your needs. Feel free to phone the ASB Home Loan Line at 0800-100-600 to talk through these issues with ASB staff.

Online mortgage calculators are available here. The latest ASB mortgage rates are available here.

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