Home Loan Rate Report

24 June 2020

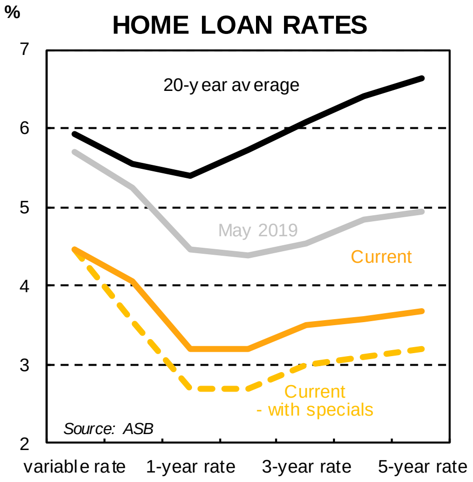
Mortgage rates drop as RBNZ pulls out the stops

- Mortgage interest rates appeared to have hit their lows in late 2019. However, the RBNZ's massive response to the COVID-19 situation has seen mortgages drop to fresh lows over recent months.
- Borrowers can lock in record low interest rates now, at rates as low as 2.69%.
- Our forecasts suggest fixing and then rolling shorter term (1- and 2-year) mortgages terms is likely to be the cheapest option over a 5-year time horizon.
- We expect mortgage rates to stay low for several years. Nonetheless, borrowers should still plan to deal with higher interest rate costs as fixed terms mature in the future, rather than budget on rates remaining this low indefinitely.

A dramatic change in circumstances

At the start of the year ASB economists thought the RBNZ would keep the OCR on hold at 1% this year and in 2021. Related to this, we also thought that mortgage rates could be hitting a low over summer and start to rise over the next few years. That view 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 stepped into bond markets to provide liquidity and drive long-term yields lower. Mortgages have dropped significantly in the wake of the RBNZ's actions.



Recap on mortgages over the past year

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.

The global interest rate backdrop, concerns over the NZ economic outlook, and the 0.75% of OCR cuts by the RBNZ delivered by August 2019 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. The RBNZ held its first OCR Review for 2020 on 12 February and retained the 1% OCR setting, and was optimistic about the economy's prospects. But all that changed considerably over March as the

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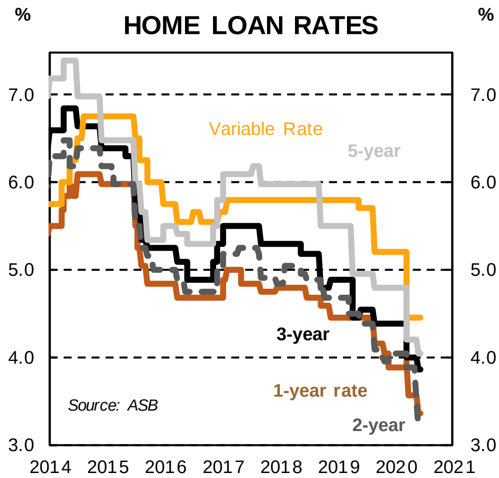
seriousness of the COVID-19 pandemic became apparent. The RBNZ joined offshore central banks and eased interest rates significantly.

The RBNZ cut the OCR by 75bp to 0.25% on 16 March, and committing to keep the OCR at this level for at least 12 months. Then on March 23, the RBNZ kick-started its Quantitative Easing programme, unveiling a large $30bn Large Scale Asset Purchase Programme to purchase NZ Government bonds. The program was subsequently expanded to include Local Government Funding Authority debt, and increased in size to $60bn in May. Quantitative easing is all about driving longer-term interest rates in the economy lower, to support demand in the economy. Although the RBNZ is buying government bonds, it expects to see retail interest rates (including mortgage rates) decline as lower wholesale borrowing costs are passed through to retail customers. And that's what has happened over recent months, with mortgage rates and term deposit rates dropping.

Where are rates now, and what happens next?

The world is quite different to what we imagined six months ago. And in that vein, we must acknowledge there is more than the usual amount of uncertainty in the outlook these days, and that adds to the challenges of forecasting. When it comes to mortgages, our core scenario is that we have an extended period (years rather than months) of low mortgage rates, with rates only around 1% or so higher than today's level in five years' time.



Could rates get even lower? It's possible. If the RBNZ cuts the OCR again, term deposit and wholesale interest rates could fall further. If that backdrop occurred, fixed-term mortgage interest rates should dip further too, but we don't think that they would fall by much compared to how far they have fallen already. And competition between lenders is always in the mix putting pressure on mortgage rates, so tweaks on particular terms are always on the cards. In saying all this, **we stress that we think the large falls in mortgage rates have already occurred over the past couple of years.** We think that any further declines will be minor compared with the declines recorded in 2018/19 discussed above. And its expensive to wait – floating mortgage rates are significantly higher than all the fixed-term rates, so you need to do some careful calculations if you think it's worth trying to time the right moment to fix if you think it isn't now.

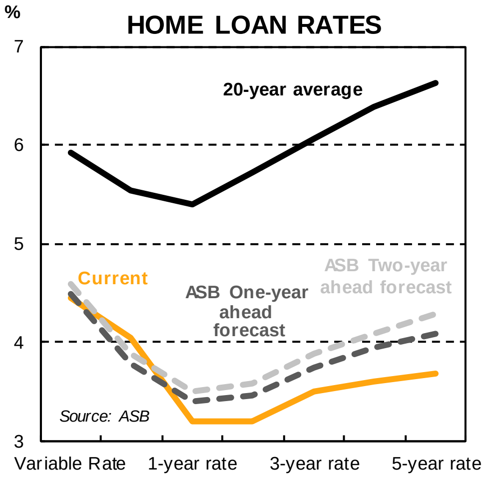
Could rates get higher? Now that rates have unexpectedly fallen to record lows, it's worth pointing out they can unexpectedly go up too. We think it is prudent for borrowers carrying debt for longer than the next couple of years to budget on mortgage interest rates being higher than they are now. Our forecast of modest rate increase s over the next five years is discussed later in the report. If the economy recovers quicker than we currently expect, we'd likely see mortgage rates to start lifting earlier and/or faster than our current forecasts.

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 term deposits, wholesale funding, and all the other sources a bank acquires funding for a mortgage (fixed in say 2018) must still be met. Those costs remain, and accordingly feed into the break costs of mortgages. With 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 is a reasonable strategy for getting interest rate certainty for a longer term. 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 he longer the term remaining, the bigger the break costs will be. There will be a term deposit 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.

What rates should borrowers plan for in the long term.

Although it seems like a long way off, we still expect the OCR to increase in a few years' time. With those increases we expect the associated higher wholesale and term deposit interest rates to eventually start to push NZ mortgage interest rates higher.



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 for a year, while we deal with the current challenges of COVID-19. But we expect that the RBNZ will want to phase in higher capital requirements for banks in the future, and that would lead to increases in bank borrowing costs and mortgages.

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. However, with all this talk about higher interest rates in a year or two, 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.

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 have certainly become an important part of the lending environment over the past seven years.

On the 30th April the RBNZ removed mortgage loan-to-value ratio (LVR) restrictions for 12 months . The decision was made to ensure LVR 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, we expect the process of offering lower rates for higher-equity lending to continue in one form or another. **Borrowers should monitor the rates on offer and discuss their circumstances and options 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. Now the curve is much flatter than historical averages. Most fixed rates are 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 over 1% below the floating rates, at or near record lows, and available with rates well under 3% (for loans with over 20% equity). At the other end of the curve, 5-year rates are 0.7% or more below floating rates, and in the mid-to-high 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 carded 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 could potentially move lower still, there is a cost of floating (at around 4.45%) in order to pick the bottom in rates. At this juncture our forecasts suggest some terms could dip a little more (particulalry if the RBNZ cuts the OCR again), but the big moves have already occurred. Rates are expected to move higher eventually, but not over the next year or two. 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 fixed rates are currently 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 terms are cheaper.	4.05/3.55	↘	↑
1-year fixed	2nd lowest rate currently. Short-term certainty. Can re-fix fairly quickly.	Less protection from near-term interest rate increases. 18-month rate is currently cheaper.	3.19/2.69	↘	↑
18-month fixed	Cheapest rate on offer.	Less of a hedge against interest rate increases if rates go up more than expected over the next few years.	3.15/2.65	→	↑
2-year fixed	2nd Lowest rate currently. Provides interest rate certainty for a reasonable period of time.	Less of a hedge against interest rate increases if rates go up more than expected over the next few years.	3.19/2.69	→	↑
3-year fixed	Certainty for a relatively low cost. Protection if rates rise quicker than expected.	Potentially more expensive than rolling shorter terms.	3.49/2.99	→	↑
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.	3.69/3.19	→	↑

*** ASB carded rate/ASB special rate (minimum of 20% equity required), 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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