Home Loan Rate Report

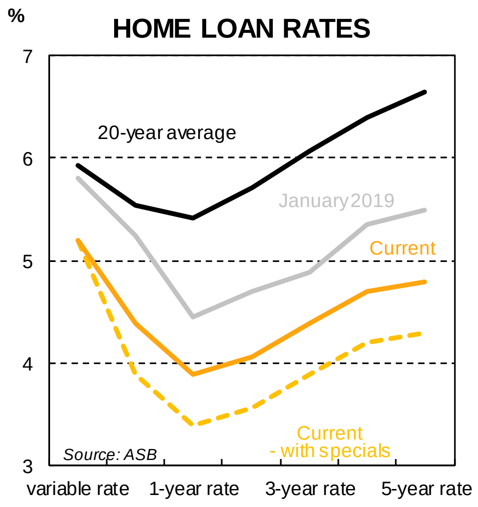
21 November 2019

A bird in the hand or two in the bush?

- Borrowers can lock in very low interest rates now, but should still plan to deal with higher interest rate costs over the long run.
- The RBNZ has surprised markets. In August it cut the Official Cash Rate (OCR) by 50bps to a record low 1.0%, but since then it has maintained that developments do not warrant more policy stimulus despite slowing domestic and global growth. We still think RBNZ will cut the OCR again in the future.
- Floating rates swiftly dropped after the RBNZ's August cut, whereas shorter-term fixed mortgage rates have eased further since the RBNZ's August cut. Longer-term mortgage interest rates had already been falling prior to this year's RBNZ rate cuts. A significant decline in these rates occurred between 2017 and early 2019.
- But if the floor in the OCR is 1.00%, mortgage interest rates are unlikely to move much lower than they are now. There is now some upward pressure on mortgage interest rates, given the upward drift in global interest rates, as markets recalibrate expectations for the RBNZ, and as pending regulatory changes take effect.

Mortgage Interest Rate developments

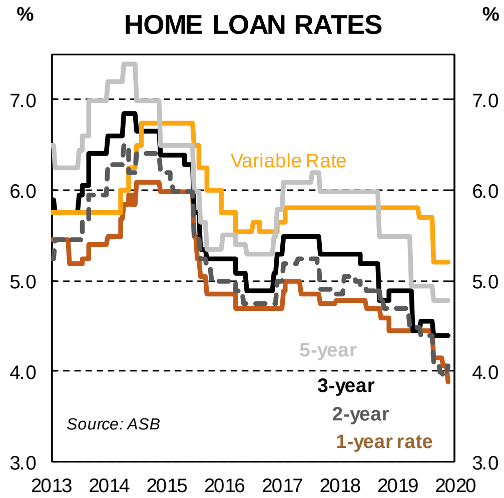
Mortgage interest rates over various tenors have fallen between 0.6% and 1.2% over the past 18 months. Mortgage interest rates are influenced by a number of factors, including the RBNZ's OCR setting, developments in domestic and global fixed-interest markets, and other influences on bank funding costs. The deteriorating global backdrop, concerns over the NZ economic outlook and the 75bps of OCR cuts by the RBNZ delivered since May have pushed rates lower. NZ wholesale interest rates reached record lows in October. Since then, improved global market sentiment and the reluctance of the RBNZ to move the OCR lower still have pushed NZ wholesale interest rates well above those October lows.



We continue to think the RBNZ will end up moving the OCR lower, and have 50bps of OCR cuts pencilled into our forecasts for next year. We expect 25bp cuts in February and May next year (OCR floor of 0.50%), but note that the exact timing will be influenced by local economic developments and global risks, which are fluid at present. We can't ignore the possibility that economic growth and inflation turns out stronger than our forecasts, and that 1.0% remains the OCR floor. By the same, token, however, we do not expect the domestic and global economies to be sufficiently strong to justify the OCR moving up anytime soon.

Chris Tennent-Brown – Senior Economist (649) 301 5915 chris.tennent-brown@asb.co.nz

The consequence of these developments is that **floating and fixed-term mortgage rates should remain very low through 2019 and 2020**, with the possibility of further OCR cuts meaning they could even dip slightly from current levels. But we stress there are a number of forces at play, and we don't expect mortgages to move in lock-step with any future OCR moves.



We expect longer-term interest rates to remain at historically-low levels over the year ahead too, but the large falls look to have already occurred. Influences on longer-term mortgage interest rates from 2-5 years include a myriad of domestic and global influences as well as expectations of RBNZ OCR settings rates. Most of these influences have provided downward pressure to NZ carded longer-term fixed mortgage interest rates for over a year now, but right now, the downward pressure on both wholesale rates and mortgages has come to an end, and reversed. **Even if our forecasts of RBNZ rate cuts next year prove correct, we don't expect to see major drops in longer-term mortgage interest rates.**

For one thing, interest rate settings are not all about mortgages – banks still need to attract savers to invest. Term deposits make up the major part of banks' funding for mortgage lending. Accordingly, the competitive pressures to attract term deposits are an opposing force on mortgage rates. While borrowers are happy about the low interest rates they are now paying, savers are frustrated by the corresponding drop in their fixed-interest income over recent years. **If, when, and by how much mortgage rates can fall in the future will in part be a function of where term deposit rates settle.**

Over the long run we still expect eventual increases to the OCR and higher wholesale interest rates to gradually push NZ mortgage interest rates higher over the coming years. On December 5, the RBNZ's will announce the new regime for bank capital requirements. If the RBNZ does significantly increase bank capital requirements (as has been signalled) this will significantly raise bank borrowing costs in the future (more discussion on this is below). **As such, 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.** However, we still expect mortgage interest rates to eventually settle at levels that remain below long-run averages of the past 20 years.

The RBNZ's LVR lending restrictions and borrowers

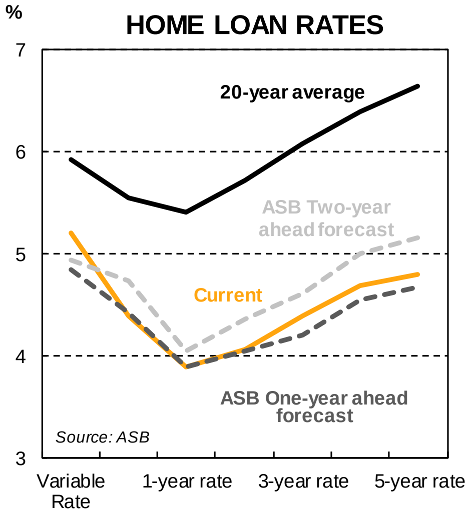
The RBNZ eased its LVR restrictions at the start of 2019, and left the restrictions unchanged in its May 2019 Financial Stability Report. Most investors are required to have a 30% deposit (was as high as 40% in 2017) and the 'speed limit' (amount of lending exceeding the LVR restrictions) remained at 5%. Owner-occupiers' deposit requirements remain fixed at 20% for the majority of loans, while the 'speed limit' (amount of lending outside this limit) has eased to 20% from 15% of new lending (was initially 10%).

Our view and the view of the RBNZ is that the loan-to-value ratio (LVR) restrictions on housing lending have been effective in reducing some of the risks associated with high household indebtedness. Having the LVR restrictions has helped keep the nationwide propoerty makret on more of an even keel despite sizeable recent fall to carded mortgage interest rates, the housing catch-up evident in a number of regional centres and the Government's decisions to shelve the Capital Gains Tax.

The RBNZ is likely to remain wary and alert to the possibility that housing market risks could quickly re-emerge. **However, our view is that the LVR restrictions will be gradually reduced over time given they were not designed to be permanent, and that they provide another barrier to home ownerhip for first-home buyers.** The RBNZ has made relaxing the LVR restrictions conditional on whether credit and house price growth remains low and if banks continue to maintain prudent lending standards. Watch this space over the coming months.

It is also important for borrowers to note that we expect the process of offering "specials" for higher equity lending (i.e. equity in excess of the LVR restriction threshholds) to remain in place in one form or another. **Borrowers should monitor these "specials", and discuss the options with their mortgage providers when deciding what to do with their mortgage.**

Bank capital requirement changes could push mortgage interest rates up



The RBNZ has proposed to significantly increase capital requirements for locally-incorporated banks in NZ. The main motivation for this is to bolster NZ financial system resilience. Higher capital requirements will likely increase the overall cost of NZ bank funding and result in higher customer borrowing interest rates. We will have to wait till December 5 for the RBNZ's announcement, with the changes to be phased in from next April. **Assuming the RBNZ does not make significant changes from its original proposal, we expect the new regime will add 50-75bps (0.50%-0.75%) to customer borrowing rates over the longer term (assuming all the impact is borne by borrowers).** This is significantly above the 20bp impact assumed by the RBNZ. It is important to note that the **impact on customer interest rates will be uneven and will depend on the perceived riskiness (and hence required capital) of the type of lending.** As such, mortgage interest rate increases for high-equity borrowers are likely to be more modest than our central estimates, whilst low-equity borrowers could face steeper increases.

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 flexability 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. **One of the characteristics of the mortgage borrowing curve is that it has remained "tick-shaped",** with 1- to 3-year fixed rates lower than both the variable and 5-year rate, although the curve is flatter than historical averages.

The lowest rates on offer vary beween the main banks, but is generally in the 1-2 year tenor, over 1% below the floating rates, and at or near record lows. At the other end of the curve, 5-year rates are circa 0.85% higher than the lowest 1- and 2-year rates, with rates all well below 5%. The gaps between some of the special rates available and floating rates are slightly wider.

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. Mortgage interest rates could potentially move lower still, but we note that they could also move higher. Current rates on offer are very low and fixing will provide some interest rate certainty over the term of the mortgage. **Borrowers could also consider splitting the mortgage into different terms to better suit their preferences for interest rate certainty versus retaining flexibility.** Although we do not expect the OCR to move higher until 2022, having the additional flexibility can come at a cost. The current carded 3-year rate is 0.8% below the floating rate (and some 3-year specials are around 1.3% lower than floating rates).

The table on the page overleaf 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 easy	• Short-term fixed rates currently cheaper	5.20/5.20		
6-month fixed	• Cheaper than floating rate • Short-term certainty • Can re-fix fairly quickly	• Less flexibility than floating • Less of a hedge against interest rate increases. • Other terms are significantly cheaper	4.39/3.89		
1-year fixed	• Lowest rate currently • Short-term certainty • Can re-fix fairly quickly	• Less of a hedge against interest rate increases	3.89/3.39		
2-year fixed	• More certainty than short-term rates	• Less of a hedge against interest rate increases	4.05/3.55		
3-year fixed	• Certainty for a relatively low cost • Protection if rates rise earlier than expected	• Potentially more expensive than rolling shorter terms	4.39/3.89		
5-year fixed	• Certainty for a long time	• Most expensive fixed rate on offer • Fixing for short terms expected to be a cheaper option over next 5 years	4.79/4.29		

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

The latest ASB mortgage rates are available here.

Final thoughts

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 interest payments, a good mortgage strategy also needs to take into account an individual borrower's cash flows, tolerance for uncertainty, and the ability to deal with changes in future mortgage payments as interest rates change. Borrowers' financial circumstances can change too, and this needs to be taken into account.

Overall, it is important for borrowers to weigh up their own priorities and make the mortgage choice that looks best aligned with their 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.

ASB Economics & Research			Phone
Chief Economist	Nick Tuffley	nick.tuffley@asb.co.nz	(649) 301 5659
Senior Economist	Mark Smith	mark.smith4@asb.co.nz	(649) 301 5657
Senior Economist	Jane Turner	Jane.turner@asb.co.nz	(649) 301 5957
Senior Economist	Mike Jones	Mike.jones@asb.co.nz	
Senior Rural Economist	Nathan Penny	nathan.penny@asb.co.nz	(649) 448 8778
Senior Economist, Wealth	Chris Tennent-Brown	chris.tennent-brown@asb.co.nz	(649) 301 5915
Data & Publication Manager	Judith Pinto	judith.pinto@asb.co.nz	(649) 301 5660

www.asb.co.nz/economics **@ASBMarkets**