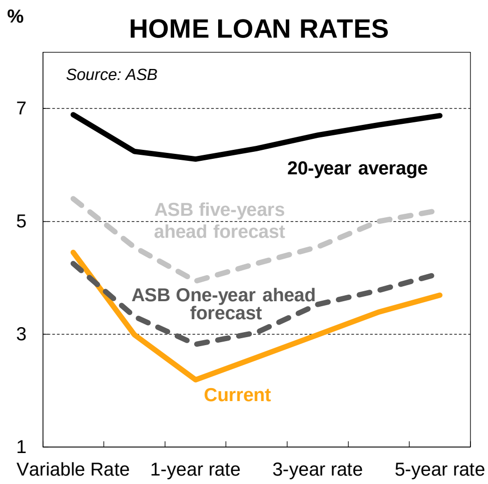
Home Loan Rate Report

18 June 2021

Long-term mortgage rates lifting

Long-term mortgage rates and other influential interest rates continue to rise

- We are past the low point for most mortgage interest rates, and long-term rates have been lifting. Our forecasts suggest some modest upward pressure on all but the near-term mortgage rates over the rest of the year.
- The resilience of the local economy over the second half of 2020 and the prospects of more improvement over 2021 impact our outlook for interest rates, including mortgages.
- ASB now expects the Reserve Bank of New Zealand (RBNZ) to start raising the 0.25% Official Cash Rate (OCR) by May 2022 – if not earlier. However, we do not expect the OCR to move up significantly over time, and we are forecasting an OCR peak of 1.25% in late 2023/early 2024. This suggests that mortgage interest rates are likely to 'settle' at still-historically low levels.
- There's still the possibility that some influences on bank funding costs could send some rates a bit lower, as we have recently seen with ASB using the RBNZ's Funding for Lending Programme to fund the ASB Back My Build variable rate of 1.79%.
- But the improving economy and rising long-term interest rates here and abroad are strong opposing upward forces on the mortgage rate outlook – particularly for the longer terms which have been rising this year.
- Borrowers can lock in very low mortgage interest rates now, with the 1-year fixed rate under 2.3% at the time of writing. However, borrowers should prepare for higher mortgage rates when this term ends.
- The RBNZ's massive response to the COVID-19 situation was a catalyst for significant reductions in mortgage rates over 2020, and a removal of the Loan to Value Ratio (LVR) lending restrictions. The LVR restrictions have come back now.
- Taking advantage of the lower rates on offer now, combined with our expectations that mortgage rates will only rise modestly over the years ahead, influence our thoughts on mortgage strategies. Fixing for the lowest-cost shorter terms and subsequently rolling fixed-term mortgages is forecast to be the cheapest option over a 5-year time horizon. However, this strategy looks increasingly exposed to the risk of a faster than expected unwinding of monetary support.
- Borrowers are prudent to plan to deal with higher interest rate costs, rather than budget on rates remaining this low indefinitely. And for those who want longer-term interest rate certainty now, the cost of fixing for two to five years is still very low compared to the past twenty years.



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Please refer to the important disclosures at the end of this document.

Dramatic changes over the past year

The RBNZ's response to the COVID-19 pandemic over 2020 had the desired effect of pushing interest rates within the economy significantly lower, including mortgage rates. Mortgage interest rates dropped to their lowest level on records going back to the 1960s in the wake of the RBNZ's actions last year. Furthermore, the RBNZ temporarily removed the loan-to-value ratio (LVR) restrictions that were impacting borrowers and borrowing costs.

We still expect the RBNZ will want mortgage rates and other borrowing costs in the economy to remain low over the year ahead. However, the improving economy means that the Official Cash Rate will not remain at record lows indefinitely. With the economy going well, a question people are now asking is when will the RBNZ start to unwind the huge amount of stimulus it has put in place. And to cut to the chase, borrowers are asking when will mortgage rates rise, and by how much?

In addition, the RBNZ put LVR restrictions back in place from the start of March and made further adjustments to investor lending restrictions in May. The RBNZ's FAQ is a good place to find out more here.

What's driving mortgage rates these days?

Mortgage interest rates are influenced by a range of factors, including the RBNZ's Official Cash Rate setting, developments in domestic and global fixed-interest markets, and other influences on bank funding costs.

Last year the RBNZ added a couple of new things to its toolbox. Firstly "quantitative easing" was added to the mix of things the RBNZ can do 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 boosting liquidity, in addition to its usual task of setting the Official Cash Rate. It has aimed to make wholesale interest rates lower than they would otherwise be if there wasn't a huge and constant buyer in the market.

Although the RBNZ is buying Government bonds (as well as some Local Government Funding Agency bonds), these actions impact retail interest rates (including mortgage rates) as well. That's what happened over the past year, with fixed mortgage rates and term deposit interest rates dropping significantly.

In December 2020 the RBNZ launched a "Funding for Lending Programme" (FLP) for banks. This programme provides another source of funding for banks in addition to the traditional retail (i.e. savings and term deposits) and wholesale markets. Funding via this channel is cheaper than term deposit and other wholesale funding, so the facility has the potential to hold down interest rates as it gets drawn on. However, the facility will only ever account for up to 4-6% of banks' total funding, which will limit its impact.

Our note on the RBNZ's recent announcements, including the Funding for Lending Programme, 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 analysis is here. 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 challenge of forecasting mortgage rates.

Where are rates now, and what happens next?

New Zealand's resilience and improving economic prospects mean we no longer think the RBNZ needs to do more to lower mortgage rates in New Zealand. To be sure, if the situation changes for the worse, then the RBNZ has options to lower borrowing costs to support the economy. And the current RBNZ settings as well as fiscal (government) support will continue to provide a lot of stimulus. Our core scenario is that mortgage rates will remain very low over the year ahead but are very likely to be at or near the low point right now.

There's still the possibility that the influences on mortgage rates (such as the abovementioned "FLP") could send some borrowing rates slightly lower. Recently ASB announced the ASB Back My Build variable rate of 1.79%, which was possible because it utilises FLP funds. But the improving economy and rising wholesale interest rates are a strong and opposing upward forces on the mortgage rate outlook – particularly for the longer terms. Floating mortgage interest rates are subject to the same pressures discussed above and are expected to remain significantly higher than fixed-term mortgage interest rates. With the relative expense of floating in mind, you always need to do some careful calculations if you think it's worth floating to time the right moment to fix.

When could mortgage interest rates move higher? In short, if the economy continues to recover as we have seen over recent months, it's likely the RBNZ will also want to begin the process of raising the Official Cash Rate (OCR) next year, which is earlier than we thought in the depths of the pandemic and associated economic downturn. We don't think OCR increases are on the cards for 2021, but we have an OCR increase pencilled into our forecasts for May next year. With the NZ and global economic outlook having improved, interest rates are moving higher sooner than we thought six months ago.

How high could they get? This depends on a host of factors including RBNZ's Official Cash Rate settings, inflation, and bank funding costs, many of which are difficult to forecast with a high degree of accuracy. Based on the ASB economics team's expectation that the OCR will peak 1% higher than current levels (at 1.25%), and our assumptions about bank funding costs and inflation forecasts, we expect mortgage interest rates will lift to levels 1-1.5% higher than they are now by 2025. However, as is often the case, the outlook is far from certain.

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 low 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 was a function of the prevailing interest rates the bank was paying for money at that time, not whatever the costs 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 recent years, 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 over a longer term at low rates. There are many moving parts in this equation, so take time to work through the numbers, and the pros and cons. 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 depositor 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 positions of both savers and borrowers.

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

For the next few years, we expect borrowers will likely be able to access mortgages at historically-low interest rates. For those that require certainly now, fixed terms are currently available at very low levels (around 2.2%-2.6% for 1 to 2 years). We expect the Official Cash Rate to increase several times over our five-year forecast horizon, starting next year. We expect the associated higher wholesale and retail interest rates to push NZ interest rates (including mortgages) higher over the next few years, and this process has already started for some longer-term mortgage rates, which have increased in recent months.

Prior to the pandemic, the RBNZ had proposed a new regime for bank capital requirements which would have put upward pressure on mortgage rates. The changes were delayed last year as part of the suite of changes the RBNZ made to support the economy. The RBNZ plans to phase in higher capital requirements for banks gradually over the coming years, and that will lead to increases in bank funding costs and, in turn, mortgages. Technical details and the timeline of the changes can be found here, and are considered within our mortgage rate forecasts.

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 the long-run averages of the past 20 years. And borrowers can lock in incredibly low long-term interest rates (around 3%-3.7%) now if interest rate certainty over a longer period is of the utmost importance.

The RBNZ's loan-to-value ratio (LVR) restrictions are back

The RBNZ first put its LVR restrictions in place back in 2013, and has tweaked them over the subsequent years. Last April the RBNZ temporarily removed the LVR restrictions. That decision ensured the LVR restrictions didn't have an undesired impact on borrowers or lenders from the mortgage deferral scheme implemented in response to the pandemic. RBNZ LVR restrictions are back now, and this is impacting lending practices. Borrowers should discuss their circumstances with their mortgage providers when deciding what to do with their mortgage. Differing levels of equity and risk can have a bearing on credit availability and overall borrowing costs.

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. It's often not as simple as 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 flat tick now, with all fixed rates below the floating rates at present (with the exception of the 1.79% ASB Back My Build variable rate). The lowest fixed rates are at the 1-year term at the time of writing. These low rates are circa 2% below the floating rates, at or near record lows, and under 2.2%. At the other end of the curve, 3- to 5-year rates are between 3 and 3.7%.

Borrowers can currently obtain certainty and a significantly lower rate by fixing their mortgages. While the future is inherently uncertain, our forecasts for mortgage rates suggest fixing at the curent low short-term fixed rates, then subsequently rolling fixed terms is likely to be the cheapest option over a 5-year time horizon. It's always the case that mortgage rates could dip lower, due to anything from RBNZ actions through to renewed threats to the economic outlook. But there is a significant cost of floating (at around 2% above what you can fix at now) in order to pick the bottom in rates. And there are also risks that rates could move higher sooner than we expect. Pick a strategy that suits your risk appetite, your need for flexability as well as the goal of 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 unexpected near-term rate increases. Other fixed terms are cheaper.	2.99	→	↑
1-year fixed	Lowest rate currently. Short-term certainty. Can re-fix fairly quickly.	Less protection from near-term interest rate increases.	2.19	↗	↑
18-month fixed	Second lowest rate on offer.	Less of a hedge against interest rate increases if rates go up more than expected over the next few years.	2.49	↗	↑
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.	2.59	↗	↑
3-year fixed	Certainty for a relatively low cost. Protection if rates rise quicker than expected.	Potentially more expensive than rolling shorter terms.	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	↗	↑

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

Final thoughts for borrowers

The 'best' mortgage rate is only known in hindsight. Still, with the discussed pros and cons for the various mortgage rates on offer we hope to give you some thoughts 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 account your personal cash flows, tolerance for uncertainty, and your ability to deal with changes in future mortgage payments as interest rates change. Everyone's financial circumstances can change, and you need to take this into account too.

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 the ASB team.

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

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