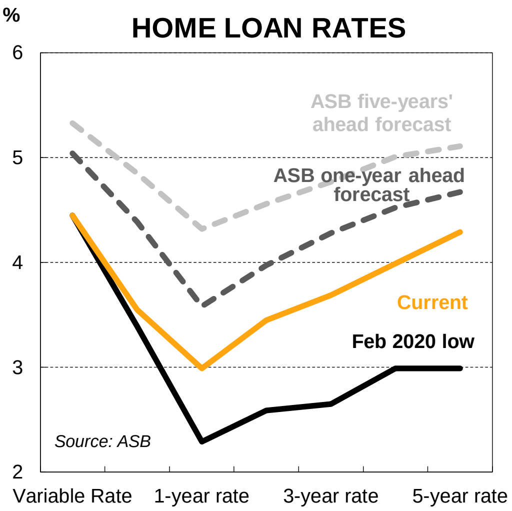
Home Loan Rate Report

14 October 2021

RBNZ lifts the OCR, mortgage rate rises expected

The RBNZ lifted the Official Cash Rate for the first time in seven years. More RBNZ rate hikes are expected, which will keep lifting mortgage rates.

- **The RBNZ lifted the Official Cash Rate (OCR) in October, as expected. More OCR increases are expected at upcoming meetings. Related to this, mortgage rates have lifted, and more increases are expected over the year ahead.**
- Despite the delta variant of COVID-19 now becoming enrenched in New Zealand, we continue to think we are past the low point for interest rates. Fixed-term mortgage rates have been lifting over 2021, and our forecasts suggest more increases are coming for mortgage rates over the rest of the year and into 2022. The resilience of the local economy since the initial shock of the pandemic, and confidence in the longer-term outlook, are the reasons we continue to forecast higher interest rates, including mortgages.



- The ASB Economics team thinks every Reserve Bank of New Zealand (RBNZ) meeting should be considered "live" for Official Cash Rate (OCR) increases. However, the arrival of the delta variant of COVID-19 and ongoing Alert Level restrictions are reminders that the situation is fluid and can change quickly.
- ASB is forecasting the RBNZ to lift the OCR back to its pre-pandemic level of 1% over the next six months. We then expect more increases, taking the OCR to a peak of 1.5% by late 2022. This suggests that mortgage interest rates are likely to move higher over this year and next, but still 'settle' at historically-low levels.
- Fixing for the lowest-cost shorter terms and subsequently rolling fixed-term mortgages has been a good strategy over recent years. However, this approach could be undermined by the prospect of a swift lift in the OCR and mortgage rates over the year ahead.
- Fixing for some of the longer terms provides interest rate certainty for the next few years at a slightly higher cost than the cheapest rates. For those who want this 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.

RBNZ delivers the first of a series of rate hikes

The RBNZ's 2020 response to the COVID-19 pandemic had the desired effect of pushing interest rates within the economy significantly lower, including mortgage rates (which dropped to their lowest level in records going back to

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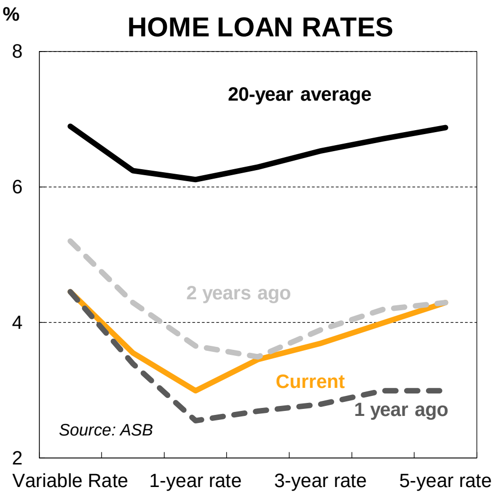
the 1960s). These super-low interest rates, combined with other monetary measures and the Government's response were key to the economic recovery and housing market strength over the past year.



With these developments in mind, ASB economists have been forecasting the RBNZ start unwinding the huge amount of stimulus it put in place last year. This process is now underway. At its October meeting the RBNZ not only lifted the OCR 25bp for the first time in seven years, but also stated that "further removal of monetary policy stimulus is expected over time".

During the pandemic the RBNZ temporarily removed the loan-to-value ratio (LVR) restrictions that were impacting borrowers and borrowing costs. The RBNZ put LVR restrictions back in place this year as the economic recovery gained momentum.

You can find out more from the RBNZ here in a FAQ page and here regarding the developments with LVR restrictions.

What's the outlook for the year?

Clear risks remain to the outlook, particularly with COVID restrictions remaining in place to stem the spread of COVID-19. But our core view remains that the RBNZ will lift the OCR 25bp in November and February to 1%, before gradually nudging up to 1.5% by the end of 2022.

New Zealand's resilience to date and our medium-term economic prospects mean we think the RBNZ will keep raising interest rates in the economy over the next year, despite the latest COVID-19 setback. Our view is every RBNZ meeting from now on should be considered "live" for an OCR increase. Assuming the RBNZ keeps lifting the OCR, the upward pressure will intensify on the shorter terms and floating rates too.

To be sure, if the situation changes for the worse, then the RBNZ has options to maintain current settings for longer or even lower borrowing costs to support the economy. In addition, fiscal (Government) support will continue. However, if the NZ and global economic outlook continues along the positive path we expect, long-term interest rates are expected to keep lifting over time as the world gets past the worst of the pandemic.

Continue to budget on higher interest rates

Mortgage rates are now past the low point and ASB forecasts suggest rates will continue to lift from current levels over the next five years. For those that require certainty now, fixed terms are currently available at very low levels. We expect the Official Cash Rate to increase several times over the year ahead. In turn, we expect the associated higher wholesale and retail funding costs to push NZ lending rates (including mortgages) higher. This process has already started for fixed-term mortgage rates, which have increased by up to 1.3% this year for the longer terms.

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 think it is prudent for borrowers carrying debt for longer than the next couple of years to budget on mortgage interest rates being significantly higher than they are now. Lenders will likely do budget calculations for loan eligibility using interest rates that are noticeably higher than the current rates on offer (i.e., over 6%).

How high could mortgage rates get?

This depends on a host of factors including the 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 1.00% higher than current levels (at 1.5%), and our assumptions about bank funding costs and inflation forecasts, we expect mortgage interest rates will lift to levels around 0.8% to 1.3% higher than they are now over the next few years, with fixed rates largely in a 4-5% range. However, as is often the case, the outlook is far from certain.

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 very low longer-term interest rates under 4% if interest rate certainty over a longer period is of the utmost importance (ASB's latest rates are here).

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 cost of that mortgage was a function of the prevailing interest rates the bank was paying for money at that time, not whatever the cost is 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.

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. In April 2020 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

The table below summarises some of the advantages and disadvantages of the different mortgage terms 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.	3.55	↗	↑
1-year fixed	Lowest rate currently. Short-term certainty. Can re-fix fairly quickly.	Less protection from near-term interest rate increases.	2.99	↗	↑
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.	3.29	↗	↑
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.	3.45	↗	↑
3-year fixed	Certainty for a relatively low cost. Protection if rates rise quicker than expected.	Potentially more expensive than rolling shorter terms.	3.69	↗	↑
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.	4.29	↗	↑

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

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. All fixed rates are below the floating rates at present (except for the ASB Back My Build variable rate). The lowest fixed rates are at the 1-year term at the time of writing, around 1.5% below the floating rates. The longer-term rates (4-5 years) are usually over 1% higher than the shorter-term rates (1-2 years), and that's the case now. All the latest ASB mortgage rates are available here.

Borrowers can obtain certainty and a significantly lower rate simply by fixing their mortgages rather than having a floating rate mortgage. There is the significant cost of the higher interest rate, but some borrowers still prefer the flexibility that comes with floating mortgages. Borrowers could also consider splitting the mortgage into different terms to better suit their preferences for interest rate certainty versus retaining flexibility.

While the future is inherently uncertain, fixing for the longer 2- or 3-year terms are prudent strategies to avoid the expected interest rate increases. It is a trade off of the cost of the higher rate (vs. rolling the cheaper 1-year rate), and interest rate certainty over a longer period.

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 right now – even as NZ is forced to adjust to COVID-19's ongoing presence – the risks still appear skewed to higher mortgage rates over time. We suggest all borrowers pick a strategy that suits personal budgets (including a tolerance for changing interest rates) and needs for flexibility, as well as the goal of minimising interest rate costs.

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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