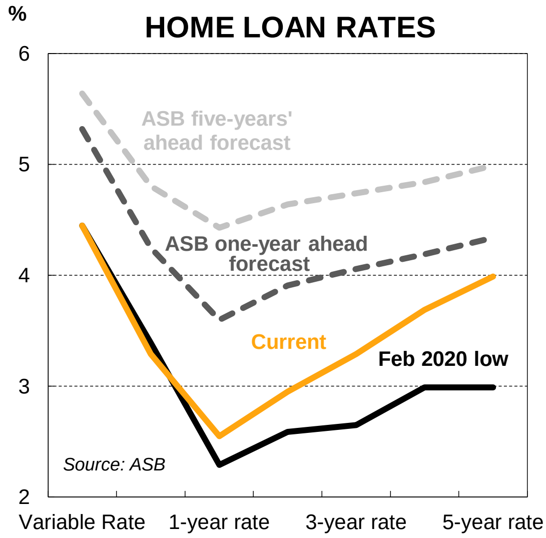
Home Loan Rate Report

20 August 2021

Mortgage rate increases remain on the horizon

Despite the COVID-19 outbreak in August causing the RBNZ to pause and assess, increases in the RBNZ Official Cash Rate and mortgage rates are expected soon.

- **The RBNZ did not lift the Official Cash Rate (OCR) in August as widely expected, instead pausing because of the latest COVID-19 outbreak and related Alert Level 4 lockdown. The pause to assess the latest developments is entirely appropriate, but OCR increases are still on the cards for upcoming meetings, and more mortgage rate increases are expected.**
- Despite New Zealand's latest COVID-19 setback in August, 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. 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, although the latest COVID-19 outbreak is a reminder that the situation is fluid. 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.
- Some influences on bank funding costs continue to keep short-term borrowing rates extremely low, an example being ASB using the RBNZ's Funding for Lending Programme for the ASB Back My Build variable rate. But the resiliance of the economy and rising long-term interest rates here and abroad are strong opposing upward forces on the mortgage rate outlook. The longer terms have already lifted several times this year.
- 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, once the current uncertainty passes.
- 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.

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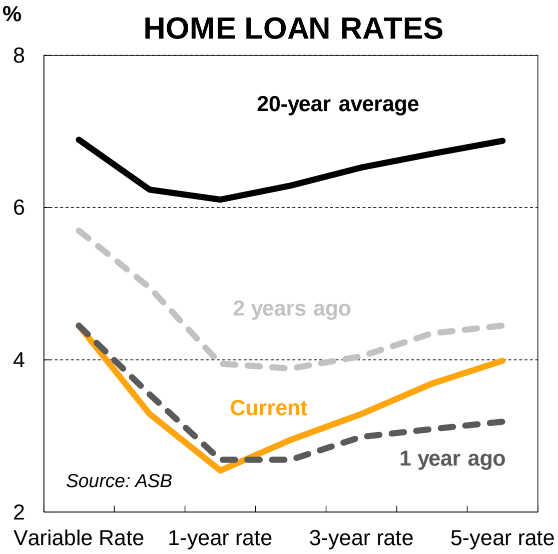
Recap: a lot has happened over the past year

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 in records going back to the 1960s in the wake of the RBNZ's actions.



ASB economists think the rapidly improving economy means that the RBNZ will soon start to unwind the huge amount of stimulus it has put in place. In fact, we thought the RBNZ would lift the OCR in August, but the latest COVID-19 outbreak kept the RBNZ understandably on the side lines. However, the RBNZ's forecasts and comments in the wake of the decision on 18 August confirm the central bank's intentions to lift interest rates. You can read more of our insights on the RBNZ's latest meeting here.

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 regarding the developments with LVR restrictions.

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. The RBNZ's quantitative easing programme was aptly referred to as the Large Scale Asset Purchase programme. Basically, quantitative easing means the RBNZ exerts 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. The RBNZ's quantitative easing made wholesale interest rates lower than they would otherwise be if there wasn't a huge and constant buyer in the market. Secondly, 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.

Last year's OCR cuts, and these two new tools, pulled interest rates in the economy down sharply. But their influence will shift. The RBNZ halted additional asset purchases under the Large Scale Asset Purchase programme from 23 July 2021. OCR increases and an end to quantitative easing mean upward pressure for interest rates in the future.

What's the outlook for the rest of the year?

New Zealand's resilience to date and our economic prospects mean we think the RBNZ will raise interest rates in the economy this year, despite the latest COVID-19 setback. Our view is every RBNZ meeting from now on should be considered "live" for an OCR increase. 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. This approach is exactly what we have seen from the Government and RBNZ during August. Some of the influences on mortgage rates (such as the abovementioned FLP) are expected to continue to keep some rates low. However, if the NZ and global economic outlook continues along the positive path we expect, long-term interest rates are expected to keep lifting. When the RBNZ changes the OCR setting, the upward pressure will intensify on the shorter terms and floating rates too.

Continue to budget on higher interest rates.

ASB forecasts suggest mortgage rates are now past the low point and 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 interest rates to push NZ interest rates (including mortgages) higher. This process has already started for fixed-term mortgage rates, which have increased by up to 1% 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 1.25% 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 1-2% higher than they are now over the next few years. 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 incredibly 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.	3.29	↗	↑
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	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.	2.79	↗	↑
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.	2.95	↗	↑
3-year fixed	Certainty for a relatively low cost. Protection if rates rise quicker than expected.	Potentially more expensive than rolling shorter terms.	3.29	↗	↑
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.	3.99	↗	↑

*** 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. It's a flat tick now, with all fixed rates below the floating rates at present (except for the 1.79% ASB Back My Build variable rate). The lowest fixed rates are at the 1-year term at the time of writing, nearly 2% 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, our forecasts for mortgage rates suggest that fixing for the longer 2- or 3-year terms are prudent strategies to avoid iminent rate increases.

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 the risks appear skewed in the other direction, and that's behind our forecasts of higher mortgage rates over the coming months. 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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