Home Loan Rate Report

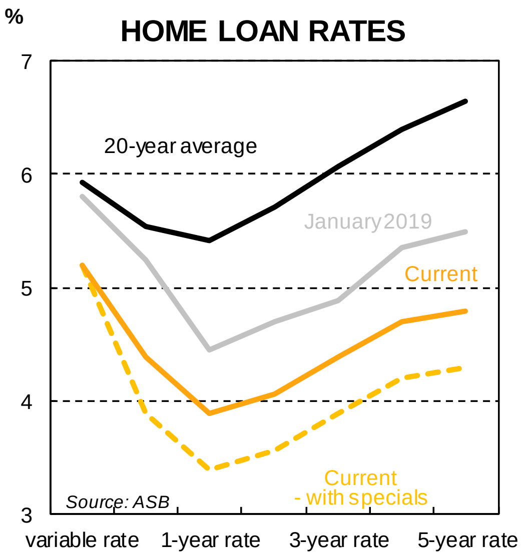
09 March 2020

Mortgage rates could dip on coronavirus response

- Mortgage interest rates appeared to have hit their lows in late 2019. However, if the RBNZ changes its view and cuts the OCR again as we now forecast, we could see another dip for floating and fixed rates.
- The Reserve Bank of New Zealand (RBNZ) cut the Official Cash Rate (OCR) to a record low 1.0% last August. In February 2020 it has maintained that developments do not warrant more policy stimulus despite risks to the outlook (including the coronavirus). As global concerns mount, we think the RBNZ will join other central banks and cut the OCR again soon.
- Borrowers can lock in very low interest rates now, and we may see even lower rates over the coming months.
- Nonetheless, borrowers need to plan to deal with higher interest rate costs as fixed terms mature over the years ahead.
- Our forecasts suggest fixing and then rolling shorter term mortgages terms is likely to be the cheapest option over a 5-year time horizon.

ASB changes interest rate forecasts

Only one month ago ASB economists thought the RBNZ would keep the OCR on hold at 1% this year and next, unless the impacts of the coronavirus prove to be much larger and more prolonged than the short, sharp impact viral outbreaks tend to have. Related to this, we also thought that the low point for domestic interest rates, including mortgages could be occurring about now. That view has now changed.



Because of the swiftly-changing COVID-19 situation, we expect the RBNZ to now respond with OCR cuts. Fiscal policy will be the best targeted response, but the likelihood of a prolonged economic hit from the COVID-19 outbreak also warrants extra monetary support. We have pencilled in 25bp OCR cuts for March and May, though the outlook will remain fluid.

Mortgage Interest Rate developments

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.

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The global interest rate backdrop, concerns over the NZ economic outlook, and the 0.75% of OCR cuts by the RBNZ delivered last year combined to push domestic interest rates lower last year. NZ wholesale interest rates reached record lows in October 2019 and mortgages reached the current low levels soon afterwards. Over late 2019, improved global market sentiment and the reluctance of the RBNZ to cut the OCR further have pushed NZ wholesale interest rates above those October lows. 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.

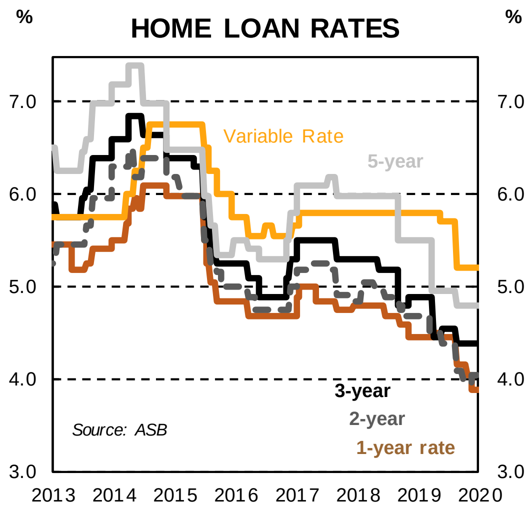
The RBNZ held its first OCR Review for 2020 on 12 February and retained the 1% OCR setting that has been in place since last August. The RBNZ's economic outlook (which included preliminary estimates of the impact of the COVID-19 outbreak on the NZ economy) suggested little need for further OCR cuts. Beyond the threat of the coronavirus, the RBNZ was optimistic about the economy's prospects and confident that it has stimulated the economy enough to meet its inflation and employment objectives.

Until very recently, other central banks had also sounded reluctant to respond to the coronavirus threat to the outlook. But that bar has quickly dropped considerably over early March. The US Federal Reserve's decision to cut the Federal Funds rate by 50bp between scheduled meetings has strongly reinforced our view of a low threshold for the RBNZ to act. Similarly, the Reserve Bank of Australia's cash rate cut on 3 March reinforced the message that central banks are reacting to the coronavirus threat swiftly. We have also seen local yields approach record lows and markets price in the greater likelihood that the RBNZ will join other global central banks and trim policy interest rates.

Mortgage rates low in the short term, and could even dip a little more

We have pencilled in 25bp cuts for each of the March and May RBNZ meetings, taking the OCR to a fresh low of 0.5%. What we'd warn at this point is the range of outcomes remains wide, and this forecast should be viewed as an indicative bookmarker. **The consequence of these developments is that floating mortgage interest rates will likely dip further if the RBNZ cuts the OCR in the coming months as we expect.**

Influences on fixed-term mortgage interest rates include a myriad of domestic and global influences as well as expectations of RBNZ OCR settings. Most of these influences provided downward pressure over much of 2018 and 2019. Late last year the downward pressure on both wholesale rates and mortgages looked like it was coming to an end, but the COVID-19 threat has seen the pressure return.



Fixed-term mortgage interest rates could dip further too if the RBNZ cuts the OCR, and wholesale interest rates fall further. In saying this, we stress that large falls in carded mortgage rates have already occurred over the past couple of years. We think that any declines will be minor (circa 0.25%-0.5%) compared with the declines recorded in 2018/19 discussed above.

A bird in the hand, or two in the bush?

Low mortgage interest rates can be locked in now. Our forecasts suggest mortgage interest rates could get slightly lower over the coming months, but there is a cost in not fixing now which is broadly the difference between floating rates and the fixed term rates currently on offer (over 1% per annum for some terms). Borrowers should focus on minimising borrowing costs over the life of their mortgage, rather than attempting to pick the bottom, potentially paying more costs now (by floating) than future savings (by eventually fixing).

Higher rates than today should be planned for in the long term.

We still expect increases to the OCR in a few years' time and the associated higher wholesale interest rates to start to push NZ mortgage interest rates higher over the coming years. Furthermore, last year the RBNZ announced the new regime for bank capital requirements. The changes are to be phased in over seven years, and could potential deliver significant increases in 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, with all this talk about higher interest rates, borrowers will be pleased to know we still expect mortgage interest rates to eventually settle at levels that remain well below long-run averages of the past 20 years.

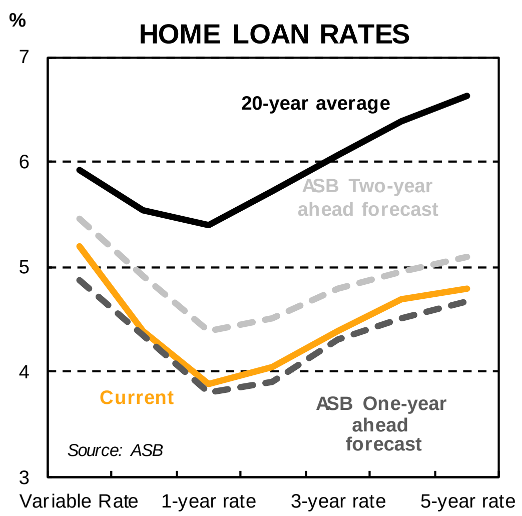
The RBNZ's LVR lending restrictions and borrowers

The RBNZ eased its LVR restrictions at the start of 2019, and left the restrictions unchanged in its May and November 2019 Financial Stability Reports. 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) was 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 property market on more of an even keel despite the sizeable recent falls 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 earlier last year. However, the LVR restrictions have made it more difficult for some households to get onto the housing ladder.

The RBNZ have kept the LVR restrictions having been alert to the possibility that housing market risks could quickly re-emerge. The RBNZ has made relaxing the LVR restrictions conditional on whether credit and house price growth remain low and on banks continuing to maintain prudent lending standards.

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 thresholds) 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 expected to push mortgage interest rates up

The RBNZ has announced significantly-increased 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. The changes will start to take effect from July, and be phased in over a seven-year period. **Our mid-point estimate is that the changes will add up to 50bps (0.50%) to overall 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 is likely to be uneven and dependent 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 considerably 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 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.

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 between the main banks, but are generally in the 1-year tenor, over 1% below the floating rates, at or near record lows, and under 4%. At the other end of the curve, 5-year rates are circa 0.9% higher than the 1-year rates, and 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. As discussed above, mortgage interest rates could potentially move lower still. At this juncture our forecasts (assuming the RBNZ cuts the OCR) suggest floating and fixed mortgages can dip a little further before ultimately moving higher over the next few years. 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.**

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.

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.

The latest ASB mortgage rates are available here.

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 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 cheaper 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.

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