

Fixed vs. Variable Rates

There are often comments in the media about whether borrowers are better off fixing their home loan interest rates and when the best time to do it is. Unfortunately there is no crystal ball that can predict what will happen to the economy and interest rates in the future, but we can give you an insight into how to determine whether you would be better or worse off if you fix your loan at a specific point in time.

Lenders' variable interest rates vary approximately in parallel with the Reserve Bank of Australia's "cash rate". Variable rates are a reflection of the current economic climate. The Reserve Bank uses the cash rate as a blunt instrument to try to control inflation – when inflation is getting too high (typically when the economy is doing well) the cash rate goes up; when the economy is weakening (inflation usually is lower) the cash rate often comes down.

Standard Variable Home Loan Interest Rates 1959 - 2010



Fixed rates could be termed predictive. That is, lenders look at the cost of holding money at a certain rate for a specific term and determine the interest rate. Fixed rates are generally higher than variable rates to take into account possible rises in the cash rate. So when a borrower takes a fixed rate, they are predicting that the variable rate will rise above the rates which they have locked in. Lenders may offer fixed terms between one and ten years; however, most fixed rate terms are between one and five years. Once a

borrower has locked in their fixed rate, they will start paying the fixed interest rate straight away. For example, if a borrower fixed their loan today at a five-year fixed rate which is 2% higher than the variable rate, the borrower would start paying an extra 2% interest right away.

Different interest rate scenarios

The graph below shows an example of the first five years of a \$300,000 variable rate loan over a 30-year term. The grey, blue and orange lines show the variable interest rate starting at 5.7% while the teal line shows the fixed interest rate at 7.7%.

If the borrower considers fixing initially for five years at 7.7% (teal line on graph) and the variable rate doesn't change from 5.7% during that fixed term (orange line) then, in addition to the borrower's annoyance at fixing at a higher rate, the borrower would pay \$30,000 in extra interest over the five years.

If the variable interest rate rose in a straight line (blue) from 5.7% to 7.7% over the five-year fixed term, the extra interest paid if the borrower had fixed their interest rate would be \$15,000.

To break even, the initial interest rate of 5.7% would need to rise along the grey line to reach a rate of 9.7% after five years – in order to pay the same amount of interest as if the loan had been fixed at 7.7% for the same five year period.

This is now the borrower's decision; are the variable rates likely to reach this rate? If so, for how long will they remain at this rate?

An example of different interest rate scenarios for the first five years of a \$300,000 home loan



It is important to consider the following questions carefully:

1. What is your current variable rate?
2. What are the current fixed rates with your lender?
3. What loan features do you really need?

Remember that there are benefits and pitfalls with both fixed rate loans and variable rate loans:

- Variable rate loans tend to be more flexible, with more features (e.g. redraw facility, ability to make extra payments); fixed rate loans typically do not.
- Fixed rate loans have predictable repayment amounts over the fixed term, variable rate loans do not.
- If you get out of (“break”) a fixed rate term, you may be charged significant extra costs.

The table below is provided to help you work out the potential outcomes of different fixed and variable interest rate scenarios.

A Coastal Lending Services broker can guide you through the decision and answer any questions you may have.

	Calculation example	Additional information to help you	Your calculations
A	A = Your current home loan balance e.g. 300,000	Check your last home loan statement for your balance	
B	B = Current fixed rate e.g. 7.7%	See your lender’s website for their current fixed interest rate	
C	C = Current variable rate e.g. 5.7%	Check your last home loan statement for your current interest rate	
D	D = Fixed term length e.g. 5 years	This is the number of years that your current fixed rate (B) would be fixed for	
E	E = B - C e.g. 7.7 - 5.7 = 2	The difference between the fixed rate and the variable rate	
Scenario 1. If the borrower fixes their home loan at B for D years and the variable interest rate (C) does not change over the time period, this is the total extra interest the borrower would pay over D years.	F = A x D x E ÷ 100 e.g. 300,000 x 5 x 2 ÷ 100 = \$30,000	See front page and refer to orange line and orange striped area in the example	
Scenario 2. If the borrower fixes their home loan at B for D years and the variable interest rate increases in a straight line to meet the fixed rate, this is the total extra interest the borrower would pay over D years.	F x 0.5 e.g. 30,000 x 0.5 = \$15,000	See front page and refer to blue line and blue shaded area in the example	
Scenario 3. If the borrower fixes their home loan at B for D years, the variable interest rate would have to rise to this interest rate in order for the borrower to pay the same amount of interest (Break even). If the variable rate rose higher than this interest rate, the interest saved with a fixed loan would be greater than the interest paid.	B + D e.g. 7.7 + 2 = 9.7%	See front page and refer to grey line and grey shaded area in the example	

*You can use this formula when deciding between any fixed interest rates versus the current variable interest rate. Note: You will need to change the fixed term length in D, e.g. for a 2 year term rate, insert “2” into the calculation.