A fixed or floating mortgage rate: Does it matter?

In times like now, when there is great uncertainty about what will happen to interest rates over the next few years, mortgage borrowers get lots of advice regarding choosing between fixed or floating rates. Unfortunately a lot of it is not well founded.

For example, suggestions that locking into a fixed rate before rates increase will be beneficial in terms of interest savings are, basically, rubbish. That displays a lack of knowledge of how banks set loan interest rates.

A bank will (with some minor exceptions) set its fixed and variable loan rates based on its expectations of the future direction of interest rates. And they have armies of economists and analysts factoring all available information into those expectations.

If they expect rates to increase, the fixed rates will be set accordingly higher than the floating rate on loans. Conversely, fixed rates will be set lower than floating if they expect rates to fall.

This simply reflects the fact that they will face a similar relationship in raising funds on a short term floating rate versus longer term fixed rate basis. Market expectations of higher future interest rates lead to a higher cost of long term fixed rate borrowings compared to shorter term floating rate funding.

Aiming for a fixed profit margin over the life of the loan, higher long term fixed rate borrowings get transferred by the bank into higher fixed rate loans. In those circumstances, the lower floating rate is expected by the bank to increase over time in lockstep with market interest rates to achieve the same profit margin over the life of the loan. Expected interest payments over the term involved are pretty much equal.

Now, you may disagree with the bank's expectation of future interest rate movements, which is implicit in its rate setting, and want to back your judgement! Good luck, but I'm not at all sure that the average mortgage borrower has more information and analytical skills than the bank to enable better prediction of interest rate trends!

Of course, even the banks can, and do, get it wrong. The future rarely matches expectations. And this raises the critical consideration for the borrower. How do the risks they face in choosing between the two types of loans differ?

Cash flow repayments are locked in over the term of the fixed rate loan, which can be advantageous for budgeting and household financial risk management. In a floating rate loan they will vary with movements in market interest rates, and the borrower may face unpleasant or pleasant surprises.

The ability to cope with repayment variations is thus critical to the decision. While the fixed term rate appears to remove this risk, when the term expires there may be a nasty shock regarding a new rollover rate if market rates have changed dramatically (as US borrowers found in the sub-prime crisis of 2008).

Banks can partially protect floating rate borrowers from cash flow risk by changing the term of the loan – keeping payments constant and extending the term of the loan if rates increase. But there is not much scope for that if the loan is recent and the loan to valuation ratio high.

Of course, there are always special cases, evidenced by the fact that there can be variations in the rates offered by different banks. That can reflect differences in the expectations held – after all forecasting is problematic, although in this case not completely a mug's game.

So, if one bank offers fixed rate loans at a lower margin over their floating rate loans than do other banks, that may be a case for choosing their fixed rate loan over that of their competitors (if risk considerations lead to a desire for a fixed rate loan). But the difference could also reflect a host of other explicit and implicit costs which the borrower needs to be aware of. And some banks may be setting rates aimed at exploiting cohorts of borrowers biased towards one or the other type of loan.

Some small banks may also offer different packages of rates because of a wish to induce borrowers into either fixed or floating rate loans which better reflect characteristics of their funding mix. But for banks of any substantial size, this is highly unlikely. They are able to use wholesale and derivative financial markets to manage this asset-liability mismatch risk.

So ultimately for the borrower, beware of advice which suggests either fixed or floating is likely to be cheaper. Considering the risks of the alternative types of loans, and characteristics of the lender is the critical step.

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