**Mortgage Interest Rates and Mortgage Contracts**

In the current dog-fight over the alleged rapaciousness of banks in increasing mortgage interest rates above cash rate increases to maintain arguably exorbitant profit levels, one simple fact tends to get overlooked. Australian home-buyers sign a mortgage contract with banks which gives banks the right to change the loan interest rate whenever and to whatever they want.

Changing the form of mortgage contracts would defuse much of the current debate.

The standard variable rate mortgage loan in Australia has long had this characteristic, where borrowers place themselves at the mercy of lenders with regard to future interest rates they will have to pay. Foreigners find this truly amazing, being more used to either fixed rate or adjustable (indicator linked) rate loans. If Australian borrowers are sufficiently naïve to give this power to banks, perhaps they cannot expect to be treated in any other way.

Historically, Australians acceded to such contracts because housing loan interest rates were controlled by governments, and because they had virtually no bargaining power when confronting an oligopoly of large banks. We should not go back to government interest rate controls, but governments could force banks to adopt different loan contracts which would be socially beneficial.

The alternative to a variable-at-the-bank's-discretion floating rate loan would be a loan in which the interest rate is tied to some fixed margin (set at the outset of the loan) over a relevant indicator lending rate. In such a loan, the borrower is still exposed to movements in the general level of market interest rates, but not to other discretionary changes by the bank.

Why don't banks themselves introduce such loans and get rid of the political opprobrium the current situation involves? Why would they – name calling and bank bashing rolls off the tough hides of bankers like water off a duck's back, but the current mortgage structure makes their risk management job (for which they are paid large salaries) much, much, easier.

As well as movements in general market interest rates being passed onto the home borrower, for them to bear this risk, banks are also able to pass on the consequences and risks of any errors they make in their funding and interest rate risk management choices. A bank which is funding housing loans in a way which subsequently becomes relatively expensive can simply increase the rate it charges to existing borrowers.

While such funding (or interest rate risk management) errors will affect the bank's ability to compete for new borrowers, existing borrowers have limited ability to avoid wearing the resulting costs. Paying out an existing loan to shift to another lender is a costly exercise, and less appealing when all that is on offer is more of the same from a limited number of major players.

If instead, adjustable rate mortgages (a fixed margin over an indicator rate such as the official cash rate) were adopted, the situation would be markedly different. New borrowers may face a different margin to existing borrowers because the current cost of bank funding relative to the indicator rate has changed. They could make conscious decisions about the merits of taking a loan which locks in that margin (or taking out a fixed rate loan) and banks can structure their funding to avoid taking on interest rate risk.

Existing borrowers would be protected from changes in interest rates other than in the indicator rate which reflects market trends. They would not be exposed to risks arising from poor funding choices or poor interest rate risk management by their bankers.

Of course, there are many details involved in structuring loans this way. It may be too risky for banks to fix the margin for very long periods (because the structure of interest rates may change), suggesting that contracts involving a fixed margin for some period (and ability to exit to another lender at the end of that period) might be appropriate. Whether the cash rate or a wholesale market rate such as the Bank Bill Swap Rate is an appropriate indicator rate is also another design issue.

But regardless of those complexities, it is clear that the current, historically inherited, internationally anomalous, mortgage design we have is creating problems. And while some of those problems affect the banks, they are unlikely to collectively give up arrangements which enable them to pass on risks to customers. Those risks should preferably fall on management and shareholders, and that could be readily achieved by government leadership to bring Australian mortgage loan contracts into line with the reality of twenty-first century financial markets.

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