MORTGAGE INSTRUMENTS

Fixed and variable mortgage rates in West Germany

Credit institutions in the Federal Republic of Germany provide a wide range of facilities to finance construction. There are not only different forms of loans but also combinations of different financing instruments. Such combined financing often consists of a mortgage loan and a bausparleihen (building-saving loan). These forms of financing have proved successful in the Federal Republic in providing housing finance for individuals.

Mortgage loans

The basis of any construction financing is a loan secured by a first mortgage. A typical feature of such loans is that they are granted for a period of up to 30 years. The liquidity burden imposed on the borrower is kept as low as possible with a repayment rate of 1% to 2%. In view of the average income position, housing finance can be afforded solely by means of this low repayment rate. Mortgage loans are usually repaid in equal instalments, consisting of interest and repayment components. A first mortgage may normally be granted with a variable interest rate. The credit institutions convert deposits into long-term loans within the limits laid down in the German Lending Statute. Since deposit interest rates are not fixed for the entire period of the deposit but are adapted to conditions in the capital market in the interests of the saver, in principle these mortgage loans also can only be granted with a variable interest rate.

In view of the limitation on the amount in relation to the value of the property, a mortgage is a loan with a relatively low degree of risk. The German Lending Statute and its implementation provisions therefore impose certain conditions on such loans, which in turn have a beneficial effect on the conditions of the credit institution in favour of borrowers. The interest rate for a mortgage loan is at the lower end of the capital market rate. Compared with other loans, a mortgage loan — in terms of interest rates — is therefore a relatively favourable form of finance.

In general, both the level of, and changes in, the rate of interest for a mortgage loan are made dependent on the general trend in the capital market. The terms of the loan are determined by the cost of procurement or the terms of refinancing. Two forms of mortgage loans are offered, i.e. at an interest rate which remains unchanged for several years, or at a variable interest rate. This is due to different refinancing by the credit institutions.

If mortgage loans are refinanced by the sale of bonds, the nominal interest rate is determined by the period of the bond. In relation to the borrower the period of the loan is usually about 30 years. However, the credit institution necessarily refinances it from several successive bond issues for shorter terms. Depending on the situation in the capital market, the period of bonds varies from four to 10 years. The interest rate for the loan must be adapted upon the expiration of this period to the new rate of the continuation loan.

Mortgage loans which are refinanced from deposits received are granted with a variable interest rate. The credit institutions convert deposits into long-term loans within the limits laid down in the German Lending Statute. Since deposit interest rates are not fixed for the entire period of the deposit but are adapted to conditions in the capital market in the interests of the saver, in principle these mortgage loans also can only be granted with a variable interest rate.

Any fluctuation in the deposit interest rate necessitates a corresponding upward or downward adjustment to the loan interest rate. If the general level of interest rates rises, the rate for mortgage loans also goes up. Conversely, if deposit interest rates fall, the rate for mortgage loans follows this trend. It may even fall below the rate agreed at the date when the loan was granted.

Fixed or variable interest rates?

In periods of low interest rates borrowers are obviously very interested in fixed rate loans, in order to maintain the low rate for as long as possible. Uncertainty remains regarding the situation in the capital market at the date of subsequent financing. If the new rate is fixed during a period of high interest rates the borrower must accept the higher rate, which will then be considerably more expensive for him.

The period for the fixed interest rate is usually four to five years, but

'Repayment period up to 30 years'

graded, due to the lending restrictions imposed on credit institutions, for an amount not exceeding 50% of the value of the property. This has two consequences for borrowers, with regard to the terms of the loan and to the combination of different financing instruments.
shorter or longer periods are also possible. The interest rate agreed for the loan remains unchanged during this period. A new agreement must be concluded upon its expiration. The new rate is usually determined on the basis of the general level of interest rates prevailing at the time. Neither the borrower nor the bank knows what the situation will be at that date in the capital market, which will determine the general level of interest rates.

Which of the two possibilities is better for the borrower will not be known until the loan is repaid. The actual cost depends on interest rate levels throughout the period of the loan. Reliable forecasts cannot be made with a loan period of 30 years.

This uncertainty, which is in principle shared by both borrower and credit institution, may be reduced by certain additional criteria, since the advantageous terms of a loan are not determined solely by the level of, and changes in, interest rates. Although the possibility of having a fixed interest rate for a long period favours fixed rate loans during phases of low interest rates, flexibility is, on the other hand, an advantage in favour of loans with variable interest rates.

For example, a variable rate loan may be utilised in instalments. The borrower saves costs as he does not have to resort to bridging loans and can still exploit opportunities for discounts. This is particularly important to him when he is making large payments himself, which may prolong the construction period considerably.

With a fixed rate loan a bank will usually demand a commitment fee, due to the particular refinancing situation. This is also an additional expense for the borrower, which will become appreciable if there are unforeseen delays in the construction work or the construction period is extended. This expense does not normally arise in the case of a loan with a variable interest rate.

Finally, in the case of a fixed rate loan it is also usual to impose a redemption fee, which the borrower has to pay if he repays the loan for any reason before the expiration of the fixed rate period agreed or wants to increase the repayment instalments. Such a fee is not imposed in the case of loans with variable rates. With such a loan the borrower can make extra repayments or occasionally repay a higher amount, without incurring additional expenses. He can thus repay his loan quickly and reduce the period of the loan depending on his own financial position.

Bauspararlehen (building-saving loans)

The terms of these loans differ in two important respects from mortgage loans, with regard to the period (usually 10 to 12 years) and with regard to the interest rate (4% to 5%), depending on the type of bausparvertrag (building-saving contract).

These special terms, differing from those applicable to capital market loans, are due to the fact that the building-saving system is independent of fluctuations in the capital markets and the general level of interest rates. The bausparkollekktiv (building-saving scheme) is a self-contained financing system. The constant interest rate for the building-saving loan is possible because the rate paid to savers is also independent of capital market rates.

A borrower cannot usually finance his entire project exclusively from either a mortgage loan or a building-saving loan. Due to the differences between the two forms of loan, a private borrower must therefore resort to a combination of both forms of financing.