Mortgage rates – fixed and variable options

Mark Boleat examines the advantages and problems of the main types of loan instrument

BY THEIR very nature, loans for house purchase need to be long term. Ten years is the minimum that is acceptable, and 25 years is common in many countries. Funding loans with such a long term poses problems for financial institutions, especially when a borrower may wish to redeem his loan at any time. Broadly speaking, the options are a loan with a variable rate which, perhaps, poses problems for the borrower; a fixed rate loan which may pose problems for the lender; and loans with fixed rates for limited periods of time, which in certain circumstances can be a useful compromise. This article examines, from a theoretical point of view, the various loan instruments.

The present position

An examination of housing finance markets shows that the complete range of mortgage instruments is in use. At one extreme is the position in Britain, and many other countries, whereby house purchase loans carry interest rates that are variable at the discretion of the lender.

Mortgage deeds in Britain allow building societies to change the rate of interest at any time. There are no limits on the frequency of changes, or the extent of any increase or decrease, nor is the interest rate formally linked to any other rate of interest.

A modified version of the British system can now be found in the USA, where a significant proportion of loans are what are called adjustable rate mortgages. The main difference between the American and British positions is that in America mortgage rates must be related to an index not under the control of the lender, and market circumstances generally require a limitation on the extent to which mortgage rates can be increased in any one year and over the life of the loan (two percentage points and five percentage points are fairly common).

Traditionally, Canada was noted for the roll-over type of mortgage, whereby loan rates were fixed for five years at a time, although repayments were based on a 25-year annuity table. At the end of five years the borrower could automatically take out a further five-year loan at the new fixed rate. Recently, shorter terms have been more common, but the principle remains the same.

At the other extreme, rates can be fixed throughout the life of the loan. This was the common position in the USA until recently and, indeed, many loans are still at fixed rates. Denmark remains as one country where loans are almost entirely made at fixed rates of interest.

If one can detect a trend over the past few years it has been towards the introduction of greater variability. This is partly explained by the financial problems which have been encountered by using fixed-rate loans, covered in more detail below, and also by greater volatility, at least until recently, in short-term interest rates. Some countries, for example the USA, have introduced variable rates, while in other countries, for example Italy, the period for which loan rates have been fixed has been sharply reduced.

Interest rate volatility

It is, of course, the case that if the general level of interest rates does not vary, then it matters little if mortgage rates are nominally fixed or variable; the fact is that they will not vary either. Thus, even though Britain had the variable rate mortgage throughout the 1950s, British mortgage rates varied hardly at all. In West Germany, interest rates have been very stable, and thus it has mattered little whether Germany employed fixed or variable rates (in practice,

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most rates in Germany are fixed).

Interest rates began to become more volatile towards the end of the 1970s. On average they were also much higher. Short-term interest rates, which in most countries had seldom previously been in double figures, increased to the 15% to 20% range, and huge fluctuations within the year were quite common. To a large extent, this reflected inflation and counter-inflation policies. These have gradually been successful, and so over the past few years interest rates have become more stable.

The increased volatility in interest rates certainly accentuated the move towards greater use of the variable rate mortgage. But now that interest rates are more stable there seems to be no significant swing back towards fixed-rate loans, although, as has already been noted, where interest rates are stable then, in practice, mortgage rates are stable regardless of whether they are nominally fixed or variable.

'Interest rates more volatile'

The lender's position

The position of the lender in regard to using fixed or variable interest rates depends largely on the method of funding used. If a lender is lending at fixed rates then it is breaking one of the cardinal principles of banking to borrow at variable rates. Borrowing short and lending long inevitably puts financial institutions at risk in a volatile interest rate climate. The American experience, considered elsewhere in this issue, illustrates this position very well.

If the lender finances fixed rate loans with fixed rate borrowing then this is prudent banking practice. Mortgage banks in Denmark, West Germany and many other European countries have adopted this safe method of financing. However, problems can arise where a borrower has the option of redeeming a loan prematurely. If the borrower is able to redeem at comparatively little cost, then a lending institution is vulnerable.

For example, if a 25-year loan has been financed with a 25-year bond, at interest rates respectively of 16% and 14%, and if interest rates then fall to 10% and the borrower redeems, the lending institution has to fund a 14% bond but with no comparable source of income. This phenomenon has been seen in France in recent years, where borrowers have been encouraged to refinance existing fixed rate loans at new, lower rates of interest.

Where a lending institution uses variable rates then it is able to operate safely if its funding is at variable rates. However, it might seem that the lender does face a problem in that if interest rates increase sharply, the ability of the borrower to repay the loan might be jeopardised, thereby leading to a substantial increase in bad debts. In practice this does not seem to have been a problem in the United Kingdom, even when, within two years, mortgage interest rates rose from 8½% to 15%.

Lenders have various methods of alleviating the full effect on borrowers, for example, lengthening the mortgage term, and, in the short term, even capitalising interest, and these methods have been sufficient to cope with the variations in mortgage rates which have been experienced in the recent past.

The borrower's position

At first sight it might seem to be stating the obvious that the borrower is far better off with a fixed rate of interest. He knows precisely what he will be paying, and can budget accordingly. This has been the defence for the fixed rate mortgage in the USA and other countries.

However, the arguments are not so clear cut. When interest rates swing violently, the ordinary house purchaser cannot be expected to judge when rates might, or might not, be rising, and in any event some may have little choice as to when they take out their loan. Some borrowers might therefore find themselves paying 15%, while had they waited another year they would be paying just 10%.

The difference that this can make in housing costs between people is huge, and what the fixed rate loan means is that some borrowers will be extremely lucky and enjoy a comparatively low rate of interest over the life of their loans, while other borrowers will be unlucky and will experience a high rate.

'Huge differences in costs'

Where a fixed rate loan cannot be redeemed under any circumstances, or unless the borrower pays the lending institutions the difference between the market value of his loan and the book value, then a borrower with a fixed rate loan is effectively tied into his present accommodation unless he wishes to take a substantial capital loss.

The housing finance institutions which have experienced the most financial difficulty have been those using fixed rate loans, especially where these have been funded by variable rate deposits. A housing lender which is in difficulty can help no one, and may even need to increase its mortgage rates across the board in order to meet losses on some of its loan portfolio. All borrowers have to pay the price in this case.

The variable rate mortgage has the advantage to the borrower that it

matters little when he takes out his loan. The system can therefore be seen as being fair between borrowers, who are not asked to judge the future course of interest rates, something which has proved elusive even for experts.

It is true that the variable rate loan means that the borrower has uncertainty with respect to hs future level of repayments. In practice this does not seem to have been a problem because of sensitive handling by lenders. It is also the case that where interest rates have been increased to very high levels this has largely reflected inflation, which has a counteracting effect by reducing significantly the real value of loan repayments.

Borrowers taking out loans with a very high rate of interest therefore know that in the event of more stable monetary conditions returning then their rate of interest will fall. Conversely, borrowers taking out a loan at a very low rate of interest know that if that rate of interest increases sharply then in all probability this will be accompanied by inflation, which will have a counteracting effect in reducing the real value of their loan repayments.

'A lottery for the borrower'

It might seem that fixing interest rates for, say, five years at a time gives the best of both worlds. Certainly this has advantages for the borrower in fixing his repayments initially for a reasonable period at the very time when mortgage repayments are likely to account for a significant proportion of his budget. However, problems arise at the end of the initial period. If interest rates are changing rapidly then some borrowers could find themselves refinancing at, say, 18%, while others are refinancing at 10%.

This is even more of a lottery for the borrower than taking out a loan initially, because then the borrower at least has a choice. This problem was experienced in Canada, and lenders reacted by introducing shorter and shorter terms, and, also allowing variable rates. Further, the Canadian Government felt it necessary to step in with financial assistance to those borrowers who were most affected.

The housing market

Finally, it is worth considering the impact of loan instruments on the housing market. It seems reasonable to suggest that fixed rate loans will tend to enhance the cyclical nature of the housing market. In the event of a rapid increase in interest rates people will be deterred from buying because they hope that interest rates will subsequently fall.

Conversely, when interest rates are low, people may bring forward purchases, fearing that if they do not they might have to pay a higher interest rate at a latter period. With a variable interest rate there is no incentive to bring forward or defer purchase, as borrowers know that the interest rate they will be paying in the future depends not on the current level of market rates, but on the rates in the future.

No detailed international study has been carried out on the effect of fixed or variable rate interest rates on housing market activity. However, it is significant that the housing recession in the mid 1980s appears to have been deepest in countries such as Belgium, the Netherlands and Denmark, where fixed rates have been prevalent. Empirical work in the USA suggests that the introduction of the adjustable rate mortgage has maintained the level of housing starts during the recent recession above that which would otherwise have taken place.

Conclusion

The use of fixed or variable interest rates for mortgage loans is deeply ingrained in housing finance markets. In Britain everyone is accustomed to the variable rate mortgage, and there is no serious suggestion that long-term fixed rate loans should be available. In Belgium the variable rate loan is simply not permitted, and it is viewed with suspicion in many other European countries. In America fixed rate loans were felt to be the norm, but recent experience has shown that there is a substantial demand for variable rate loans, especially when interest rates are perceived to be high.

'No right or wrong policy'

As in other housing finance areas there is no right or wrong policy in this area. However, it can be said that no housing finance institution can be considered to be successful if it is operating in a financially unsound way. Funding fixed rate loans with variable rate deposits and, in some cases, funding variable rate loans with fixed rate financing, must be unsound, and experience has shown this to be the case.

In countries where the general level of interest rates is relatively stable, for example, West Germany, then fixed rate loans can work quite well. However, where the level of long-term interest rates fluctuates considerably then fixed rate loans must inevitably pose problems for lending institutions, and perhaps might lead to unfairness between borrowers, although against this it can be argued that borrowers have more certainty. ■

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