Variable rate mortgages – the British experience

Virtually all the UK's £180 billion of mortgage debt is at variable rates, as Adrian Coles explains

THE vast majority of loans made by British building societies and other mortgage lenders since the end of the second world war have been on the variable rate basis. In fact, the term variable rate mortgage was itself unknown until the early 1980s because there was no need to distinguish the standard mortgage from any other type. It was taken as given that the mortgage rate was variable and it was not necessary to stress the point. This article looks at the British system of variable mortgage rates and the benefits which it has given to lenders and borrowers and the housing and housing finance markets.

Development of the variable rate mortgage

Between the 1940s and the late 1960s it was common for building societies to make mortgage loans on which the interest rate could be changed at three months' notice. Such terms existed partly to give borrowers sufficient time to reorganise their budgets so as to be able to change the payments made to building societies, but also because interest rates fluctuated relatively infrequently, and within a fairly narrow band. These factors, combined with a lack of competition for new mortgage business, meant that building societies could adopt a fairly leisurely attitude to changing their rates of interest.

During the later 1960s and 1970s, movements in the general level of interest rates became more violent and frequent. In order to retain their investors' funds, the vast majority of which were held on little or no notice, societies had to react rather more quickly to changes in interest rates if they were to prevent their investors from leaving for other institutions. Gradually societies took on new mortgage business on which they could change interest rates at one month's notice, seven days' notice and then without notice.

The current situation is that building societies generally notify their borrowers through the newspapers that their mortgage rate has been increased or decreased and then follow this up with a letter to each borrower explaining how the change has affected their own repayments, with an invitation to amend any standing instructions to their bankers.

The variable rate mortgage is probably a unique product in the British market place in that it is the only service for which the price can be changed after it has been purchased. However, the British consumer accepts that the mortgage rate can change and change violently. For example, in the middle of 1978 the mortgage rate was 8.5%, whereas by the end of 1979 it had risen to 15%. There was, however, relatively little comment on this change.

There was no consumer pressure for the introduction of fixed rate mortgages and there was little problem in recovering increased payments from existing borrowers. Furthermore, there was no significant growth in arrears or repossessions. Both lender and borrower know that in Britain the morgage rate can change after the initial contract has been signed and commit themselves accordingly.

The current system

Unlike the system of adjustable rate mortgages recently introduced in the US, British building societies, and other lenders, are not restricted in the extent to which they can change their mortgage rates. The lender has absolute discretion as to how it wishes to change rates and there is no fixed relationship between any lender's mortgage rate and either the general level of interest rates or that lender's own cost of funds. (It should be noted that some lenders are now introducing loans where the rate of interest is set at a fixed margin above money market rates. So far this type of loan forms only a small proportion of total new lending.)

The overseas observer might well wonder why it is that lenders do not increase their rates as high as possible in order to make the maximum profit out of their borrowers. The major reason is that borrowers are not captive but are able to re-finance their loans at relatively little cost. Few lenders, for example, charge redemption fees.

Also, it is conventional that the rate charged on existing mortgages is similar to (usually exactly the same as) the rate charged on new loans. Thus if a lender pushes his mortgage rate too high relative to the general level of mortgage rates it will find that it ceases to attract new business.

In recent years many building societies have introduced systems whereby the actual payments a borrower makes on a mortgage loan are fixed on an annual basis, irrespective of the number of times the actual interest rate charged to the account changes. Repayments for the next year are then fixed according to the previous year's changes in interest rates.

This gives borrowers some certainty about their level of repayments during the forthcoming year, provided they are willing to accept the fact that short-term reductions in interest rates are not immediately passed on, and that short-term increases in interest rates are accompanied by an increase in the amount of debt outstanding. Typically in the 1980s building societies have changed their rates about three times a year so the savings in administration under this type of scheme are considerable.

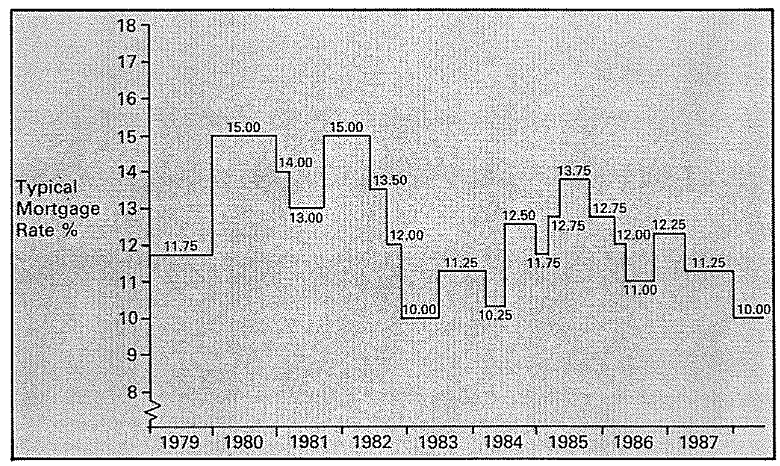
Advantages of the British variable rate mortgage

British housing finance has developed a system whereby the bulk of residential mortgages are financed by short-term deposits. Given this fact, it is essential that a variable rate mortgage system is adopted so as to maintain the solvency of lending institutions. Despite the unprecedented changes in interest and inflation rates over the past 10 or 15 years, no single mortgage finance institution in the country has failed as a result of operational difficulties.

The variable rate system has a number of other advantages. In particular it ensures that a high level of interest rates does not result in a significant decline in the number of transactions financed. Under a fixed rate system an increase in mortgage rates to, say, 15% would probably cause most potential borrowers to withdraw from the market until rates fell.

In the variable rate system an increase in mortgage rates to such a level generally results in only a modest reduction in activity, as borrowers taking on new loans at the current high rate know that rates are likely to fall in the near future, and that they will not be left making high repayments for the remainder of the mortgage term.

It follows that house prices are less susceptible to violent fluctuation and mortgage lending is, therefore, safer than would otherwise be the case. Housebuilding activity also tends to follow a smoother path than under the fixed rate system.



Recent changes

Depite the advantages of the variable rate system, competition and the pressure for innovation in the British housing finance market has, in recent years, resulted in the introduction of a number of fixed rate mortgage schemes, mostly from banks rather than building societies. Typically the schemes have offered mortgage loans where the rate is fixed for three or five years with the option at the end of the term of taking on another fixed rate for a similar period or reverting to the institution's normal variable rate scheme. Such offers have proved popular and the funds allocated by the banks to fixed rate lending have been taken up by customers extremely quickly.

However, it should be emphasised tht the amount of money available has been extremely small and that probably no more than £2 billion out of an outstanding British residential mortgage debt of around £180 billion is currently on a fixed rate basis. ■

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