FIXED RATE$

False gain, or a fantastic way to get ahead?

Don't just hope for the best, find out what you need to know before deciding to fix your interest rate

BY JANE SLACK-SMITH

INVESTORS CHOICE Mortgages

FIXED RATES: False gain or a fantastic way to get ahead?

by Jane Slack-Smith, Director, Investors Choice Mortgages and Founder of Your Property Success… finding the right property at the right price, for homeowners and investors!

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No matter whether you're buying your first home or umpteenth investment property, we are here to help you find the right loan, for the right property, at the right price.

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FIXED RATES: false gain or a fantastic way to get ahead?

What you need to know if you are considering fixing your interest rate

As someone who has been in the property industry for many years and who deals with lenders and housing finance everyday, I often get asked the “million dollar question”; should I fix my mortgage interest rate or am I better off with variable?

This is not an easy question to answer because there are so many “variables” (excuse the pun) involved. In the 15+ years I have been involved in property investment I have seen up cycles and down cycles, I have seen rates go over 9% and below 4%, and I’ve also seen people caught about by trying to anticipate what the market will do next and attempting to “beat the odds”. But, it doesn’t have to be a gamble.

When fixed rates are below variable rates it is tempting to fix, because normally fixed rates are above variable rates. However there are several things you really should know before you decide.

This e-book is designed to help you avoid getting caught up in the rush and to consider what’s right for you and your family. It will give you a better understanding of the factors that influence rates, and when you’re better informed, you can make a better decision about what’s right for you, your goals and your circumstances.

At Investors Choice, we want to help you decide whether fixing all or part of loan will suit you and your current situation. However before deciding, you also need to know what affects interest rates.

But first, an insight based on history

Recent research looking at the average variable and fixed rates over the last 20 years, shows that by staying on a variable rate 70% of the time, you had a 'three in 10 chance' of saving money compare to fixing your rates for 3 years. The average rate over the same period is approximately 7.5%.

When you fix, rates can subsequently drop and you could be caught out. This has happened in the last 20 years. At one point 3 year fixed rates were 16.5% and within 2 years the variable rate dropped to 10%.

This could have cost the borrower, ie they were paying a higher repayment then if the rate was variable. However for a third of the time if you fixed for 3 years you could have saved money ie interest rates went up.

To fix or not to fix, that is the question

How do you know whether fixing is right for you? Think about it this way, the big banks have a team of the smartest economists sitting there day in, day out looking at the economy and doing analysis on how they're going to make money for the bank. So does it really come as a surprise that you have a three in 10 chance of beating the banks by fixing and coming off a winner?

So if a lender tells you that they have a three year fixed rate of 0.5-1% below the variable rate — unless they're trying to buy market share and increase their customer base—they might just be thinking about making some money. Now some lenders want to buy market share and lock in new clients so they may be prepared to take a bit of a risk that variable rates could go below their fixed rate, but all those new clients taking credit cards, personal loans, savings accounts and insurance make it worthwhile in the long term. Remember, we do actually want a profitable banking sector, otherwise we could be facing the same types of issues we have seen in the US, UK and Europe with banks collapsing. So at the end of the day, the bank making money is in their interest and also in ours.

What do you need to consider when deciding whether to fix?

As mentioned earlier, fixed rates are tempting and if you choose to go that way, the good thing is that you don't have to fix your entire mortgage. If you choose to fix your rate you might do so on only $50,000 of your mortgage, or on 50% of the total, it's up to you.

However, one of the things about a fixed rate loan that most people don't know is that you cannot have an offset account against it. You can however put extra money into it, (usually up to a limit of $10,000 p.a.) and in some instances you can even redraw these funds.

This means that if you're going fix your loan for say two years, and you believe you can save $20,000 a year for two years (or you receive $20,000 a year in bonuses or whatever) and if you already have $20,000 in savings then you might consider fixing the majority of your loan and leaving $60,000 (ie 2 years x $20,000pa in savings plus the $20,000 in savings you currently have), or even $70,000 (to allow for a buffer) as a variable loan so that you can have an offset account against it.

This becomes even more important if you are utilising an offset account for principal and interest repayments as this will reduce the term of your loan and you may also see a small interest repayment reduction.

Many homeowners today have an interest-only (IO) loan. An IO variable loan combined with an offset account can also have a dramatic result, (even if you have to pay a little more for having that IO loan). So if you were using this structure effectively you would not want to lose that by fixing your entire loan amount.

An offset account is probably one of the best savings strategies you can have. You earn no interest on these savings, so you pay no tax on those earnings, but you save the equivalent of the interest rate for the amount of savings in your offset account. An offset account is essentially a savings account, you're not putting money into the loan, what you're doing is you're putting your money against the loan, in a separate account.

Essentially, how this works (especially for an IO loan) is that on a daily basis, the lender does a review on your loan limit… let's say $230, 000, then they a look at the amount in your offset account… say $30,000, which means they're going to charge you interest on $200,000. So if your interest rate is 5.5% p.a. then you are really earning more than that (ie earnings after the equivalent interest rate and before tax), so from a cashflow point of view on an IO loan, your interest repayment is less. Now, for a principal and interest loan, what you'll find is your term of your loan comes down with the more money you have in the offset. So it reduces the interest that you pay overall.

What is the downside of fixing?

At times, there are some really appealing fixed rates. You might be tempted but first, here's an important thing you need to consider; if you fix your loan and you're planning on selling your property or even refinancing to a different bank within that fixed time period, you could actually be up for a really hefty cost called a 'break fee'. So, breaking a fixed rate loan is not something you do lightly.

Why do I need to know about break fees?

Essentially, what often happens behind the scenes is that banks gather all the 5.5% p.a. three year fixed loans together, they then sell them to investors and promise the investors a future return of 5.5% (for example). If interest rates drop then those investors are really quite happy that they're getting 5.5% and you're not really happy that you're paying 5.5% so you might think about breaking your fixed rate loan.

Now this means that the bank has to go the investor and say, "We're breaking this agreement" and the investor says, "Well I was going to earn (for example let's say) $16,000 over the next three years, so you need to pay me out for the remainder of the loan because I am losing out on my investment. Especially if I now loan the same money out and get a lower rate".

During 2009-2010 I saw people with $500,000 loans facing 'break fees' of up to $60,000. But in some cases, people opt to pay the very large break fees so they can get a lower variable rate, while others were simply trapped with the higher rates.

You need to plan ahead

If you're fixing for two years, think about what you need for the next two years. For example, if you are planning on selling your house in the next two years, then a fixed rate loan may not be in your best interest.

Interest in Advance

There is also the possibility of paying all your interest in advance for the year ahead, which many people do just before the end of the financial year for the associated tax advantages. If this idea appeals, then you should be aware that you'd need to have all the funds available to pay for the entire interest upfront. However, the benefit is that you get an even cheaper interest rate... often a 0.1% - 0.2% discount.

Fix, Float or Flip/Flop

Fixing your rates gives you the possibility of a degree of comfort and surety in your interest repayments. As we have seen, interest rates have so many different factors that we can't predict, so my advice is don't even try. Work out your personal circumstances and what suits you. The 1, 2, 3 and 5 year fixed rates might seem low compared to our 20 year average of 7.5%pa. So you might want to fix some or all of your loans now.

But bottom line, it comes down to your personal circumstances.

These are the things you need to consider:

1) What are your plans for your property in the next two, three, five years (ie the length of time you are thinking of fixing)? If you plan to sell or there is even a possibility of this, then fixing could cost you a bundle when you sell and need to break your fixed rate contract.
2) Do you have a large amount of cash or plan to get a large amount of cash that could be used to your advantage? (Not possible with fixed loans due to lack of offset account). I have a caveat on this… there is one lender who allows a fixed rate loan *and* an offset and I have used this lender personally, together with a split loan so I can move my cash from the variable to the fixed loan depending on which is higher. This is a more advanced strategy but you should be aware that it is an option, especially for those who are undecided. Call Investors Choice Mortgages to discuss this strategy.
3) Do you care that variable rates might drop below your fixed rate for maybe 1 year of the 3 year fixed loan period if it means you can sleep easier at night as you have the comfort of knowing what exactly you are going to have to pay over the term?

What if you decide to fix – but with a new lender?

A fixed rate loan is something you can consider, and lenders often offer incentives to get your business.

What you do need to do is call your current bank and ask them what the exit fees are if you leave them. If it is going to cost you $2,000 to move from one bank to the other bank and the other bank is going to give you $700 back plus charge you maybe $250 in settlement fees and their legal agreements, then it might not be worth it, unless their fixed rate is a lot more attractive than your current lender. The reality is, if you call your lender and ask what the break costs are they'll know why you are asking and they might just offer to match what you are being offered elsewhere… it never hurts to ask!

However, remember, having a financial strategy that allows you to reach your financial goals is not about cheap rates. It is about being with a lender who has the policies and products (and yes, rates) that will help you to achieve those goals.

That is why at Investors Choice we consider your long term goals and not just short term advantages... as many of those caught out by fixing, may have done.

In Summary

If you're thinking that you'd like to take the opportunity to fix, its important to weigh up the pros and cons. If you're not planning on selling your house or refinancing to another bank in the next three to five years, then there may be some advantages for you.

However, remember you may not want to fix all of your loan, you might want to keep some of it variable and that variable amount that you keep might be used to complement whatever bonuses or savings you can accumulate within that period of time by way of an offset account which is often one of the most powerful things about a variable loan.

A lot of people put their money into redraw accounts and not into offset accounts, and fixed rate loans often limit how much you can contribute to a redraw per year. However with a few lenders you can have up to 10 splits (at no additional cost), with each split allowing up to an additional $20,000 paid off the loan each year without breaking your loan contract. This is an interesting work-around if you want to fix your entire loan but still have the flexibility of putting some of your cash into the loan.
Once again, it really does come down to working with a mortgage broker who understands the pros and cons and individual lender's products, niches and policies.

However low fixed rates, in the long run they may not be right for you and your family's circumstances.

Its important that you're aware of what you can (and can't) do with a fixed rate loan and don't just get caught up in the rush to fix… you need to consider whether it makes sense for you and your personal circumstances.

Now you know some of the factors affecting interest rates, you are better prepared to consider this option. But its also imperative you speak to your mortgage broker or someone who is actually looking at *all* the lenders and understands all the different options available and how they might impact you.

At Investors Choice Mortgages, we're continuously reviewing what lenders might be best for our clients. Sometimes it's actually in the client's interest to switch lenders and get a really good fixed rate, in other instances it's not. So you really want to have an assessment as to what is right for you and the finance structure that will best support your plans and goals.

If you want to see where you stand, complete and return the form on next page, or call Investors Choice on 1800 464 810 or visit www.investorschoice.com.au

Fixed Rate Suitability Assessment

We would be delighted to assess your fixed rate suitability and review whether it will best suit your needs. And you might be interested to know that we are even able to negotiate fixed rates below what lenders are publishing, after all if you do this for a living you know who to ask, what to ask and how to ask it to secure the most competitive offering. If you'd like us to review your situation please complete the sections below:

YOUR CONTACT DETAILS:

Name: Phone: ( )

Email:

1) Find out the current balance and limit and amount of redraw in your loan/s.

Current balance: Redraw amount:

2) Current interest rate on your loan

3) Find out if your loan has an offset or redraw and how much is in it.

Amount in offset: Amount in redraw:

4) Work out how much you could save per year over the next 5 years, as this might be the amount that stays variable.

5) Call your lender and ask what the exit fees are for your current loan.
NB: Don't be tempted by their offers until you've had a complete assessment done.

Exit fees: *(also note down any terms and conditions)*

6) Write down your plans for your property/ies for the next five years; eg sell, refinance, release equity, renovate, develop etc.

Great, now we can start the process of looking at whether fixing your interest rates is in your best interest

Complete and email this page to askus@investorschoice.com.au or fax to 1800 464 841 and we will be in touch with you shortly with our assessment

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