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canberra times: q&a

Q 1: I am about to purchase a family home needing a mortgage of $400,000. I am concerned about interest rates rising too much meaning that I would find it hard to meet my mortgage repayments. Should I fix the interest rate or use a variable interest rate option?

T.O., HOLT

A 1: The decision on whether to have an interest rate fixed or variable is answered by your personal level of comfort with your debt, rather than any ambition of making money by “timing” when to move between the fixed and variable options.

For example, as you are about to take on a large mortgage, if you choose a standard variable rate of say 6.75% pa, then there is a risk that interest rates will go up, usually 0.25% a time, thereby making your mortgage loan repayments more expensive. You are rightly concerned and understand that there is a risk successive interest rate rises may increase your mortgage repayments to a level that places significant financial strain on your situation.

If for example, you instead choose a higher fixed rate of say 7.25% pa over 3 years, then you have certainty about what your mortgage repayments will be for 3 years, regardless of whether interest rates do increase over that period of time. This kind of certainly may be just what you need to establish yourself in your new home.

Generally the fixed rate will be higher than the variable rate – particularly during times of consistent economic growth - giving some room for variable rates to increase before arriving at the equivalent fixed rate. Presently however, some financial institutions are offering 2 and 3 year fixed rate loans up to 0.5% lower than their variable rate loans. This is an indication that some institutions have the view that interest rates will fall in the coming few years, likely on the back of continued slow and low growth expectations for the Australian economy.

So, while the benefit of fixing the interest rate is certainty, the risk of fixing is that you fix at a level that the variable rate never increases to, or the variable rate actually decreases over the time you have fixed your loan. In these cases you have actually paid more in interest than you could have under a variable option.

For a $400,000 mortgage, a 0.25% increase in interest rates means an extra $1,000 pa in interest payments.

If your main concern about rising interest rates is that this would lead you to experience financial stress, which may impact your family, then you should seriously consider fixing your interest rate to remove this variable from your financial planning, particularly while there are some very attractive fixed rates available right now.

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An alternative option of course is to combine fixed and variable interest rate loans, for example 50% fixed and 50% variable. This can allow you to lock in a predictable portion of your loan, while still sharing in the outcome of the variable component, whether moving up or down.

In the end, interest rates are very difficult to predict, so if you need certainty, then a fixed interest rate option is best.

Phil Thompson is a certified financial planner and authorized representative of Rise Financial Pty Ltd (ABN 86350987645), AFSL 311718, an Approved Financial Planning Association Professional Practice. Answers should be used as a general guide only and professional advice should be sought before making investment decisions.

Send your financial questions to phil@risefinancial.com.au

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