

# Fixed vs variable interest rates

Fixed rates are more closely linked to prevailing conditions in the money market, so may vary quite considerably from variable rates. Lenders may offer fixed terms between one and ten years. Once a borrower has locked in their fixed rate, they will start paying the fixed interest rate straight away. It's important to understand the potential risks before deciding to take a fixed rate loan.

## Different interest rate scenarios

The graph below shows an example of the first five years of a \$300,000 variable rate loan over a 30 year loan term. The grey, blue and orange lines show the variable interest rates starting at 5.00% p.a., while the teal line shows the fixed interest rate at 5.75% p.a.

If the borrower considers fixing initially for five years at 5.75% p.a. (teal line on graph) and the variable rate doesn't change from 5.00% p.a. during that fixed term (orange line), the borrower would pay an extra \$11,250 in interest over the five years.

If the variable interest rate rose in a straight line (blue) from 5.00% p.a. to 7.00% p.a. over the five year fixed term, the borrower with the variable rate mortgage would have paid \$11,625 more in interest than the borrower with the fixed rate mortgage.

In order for the borrower with the fixed rate to break even, variable rates would have to rise by just 1.5%.

With this in mind, you must now take a view on whether variable rates are likely to rise by this much over the coming five years and if so, for how long will they remain at that rate?

With interest rates currently hovering around record lows, it is fair to assume that interest rates will rise eventually. That said, the Reserve Bank of Australia has made it very clear

recently that the most prudent course of action at the moment is a period of stability in interest rates. As such, when and how quickly should borrowers expect variable rates to rise in the future? Unfortunately, there is no easy answer to this question. To know what will happen with rates in the future, one would need to have a crystal ball. In order to make the right decision for your needs, it is important for you to evaluate your options and consider your longer term objectives.

Do you need loan flexibility, or would you prefer a level of certainty around your repayments?

Before you choose your home loan type (fixed or variable), it is important to consider the following:

1. What are current variable rates?
2. What are current fixed rates?
3. What loan features do you really need?

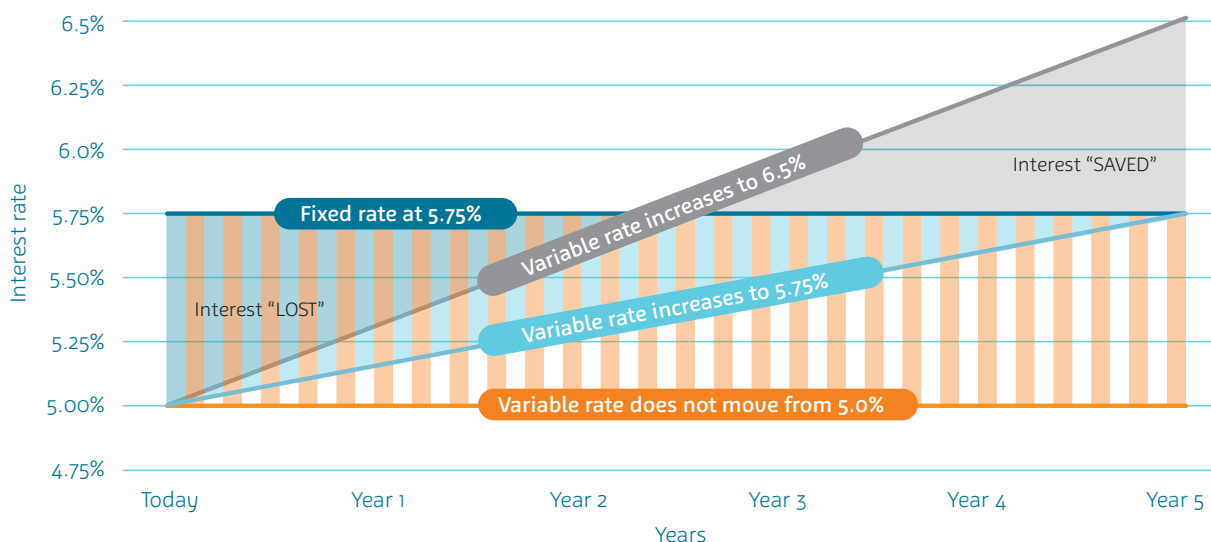
Remember there are benefits and pitfalls with both fixed rate loans and variable rate loans, including:

- Variable rate loans tend to be more flexible, with more features (eg. Redraw facility, ability to make extra payments); fixed rates typically do not have these features.
- Fixed rate home loans have predictable payment amounts over the fixed term, variable rates do not.
- To end (break) a fixed rate term before it expires, you can be charged significant extra costs.

The table on the back is provided to help you work out the potential outcomes of different fixed and variable interest rate scenarios.

As your local home loan expert, I can guide you through the decision and answer any questions you may have.

**An example of different interest rate scenarios for the first five years of a \$300,000 home loan**



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	Calculation example	Additional information to help you	Your calculations
A	<b>A = Your current home loan balance</b> e.g. \$300,000	Check your last home loan statement for your balance	
B	<b>B = Current fixed rate</b> e.g. 5.75% p.a.	See your lender's website for their current fixed interest rate	
C	<b>C = Current variable rate</b> e.g. 5.00% p.a.	Check your last home loan statement for your current interest rate	
D	<b>D = Fixed term length</b> e.g. 5 years	This is the number of years that your current fixed rate (B) would be fixed	
E	<b>E = B - C</b> e.g. 5.75 - 5.0 = 0.75	The difference between the fixed rate and the variable rate	
<b>Scenario 1.</b> If the borrower fixes their home loan at B for D years and the variable interest rate (C) does not change over the time period, this is the total extra interest the borrower would pay over D years.	<b>F = A x D x E ÷ 100</b> e.g. 300,000 x 5 x 0.75 ÷ 100 = \$11,250	See front page and refer to orange line and orange striped area in the example	
<b>Scenario 2.</b> If the borrower fixes their home loan at B for D years and the variable interest rate increases in a straight line to meet the fixed rate, this is the total extra interest the borrower would pay over D years.	<b>F x 0.5</b> e.g. 11,250 x 0.5 = \$5,625	See front page and refer to blue line and blue shaded area in the example	

\*You can use this formula when deciding between any fixed interest rates versus the current variable interest rate. Note: You will need to change the fixed term length in D, e.g. for a 2 year term rate, insert "2" into the calculation.