To fix or not to fix, that is the question.

Whether to choose a fixed or variable rate can be a difficult decision. When making such a decision it is important to factor in the advantages and disadvantages of each rate as well as the loan on offer.

Increased competition among lenders in recent years has led bankers to promote fixed rate lending, particularly in home mortgages. Also, to meet competition, personal loans are offered on both fixed and variable contracts. Up until about ten years ago, personal loans were written almost exclusively on fixed terms.

Fixing your loan

Fixed interest rates on personal loans are interest rates that remain fixed for the term of the loan.

Since the deregulation of interest rate policy, most home lenders have offered what is called a “honeymoon” rate for the first six or twelve months after the loan has been drawn. Some of these “honeymoon” rates are quite seductive, but probably do not represent the cost of funds and are an enticement to borrowers to join a particular lender at a discount, and at the end of the period the loan reverts to the market rate or a longer fixed rate.

When a financial organisation fixes the interest rate on a loan, it assumes the interest risk. An example of interest rate risk for a financial organisation is where:

- Bank Deposits are: $10,000,000 @ 0.04% variable
- Bank Loans are: $10,000,000 @ 0.06% fixed 5 years.

If the Reserve Bank of Australia (RBA) increases its cash rate by 3% to curb inflationary trends, this financial organisation will need to increase its rate on deposits by 0.03% to 0.07% in order to keep its customers. The loans are only returning 0.06% on a fixed basis and cannot be increased. In this exaggerated case the financial organisation could only operate at a loss.

When pricing fixed rate loans, financial organisations tend to make provisions in the rate to allow for the possibility of early repayment of loans and to build in a factor that represents the risk element.

Opting for variability

Variable interest rates are interest rates that rather than staying constant throughout the life of the loan, reflect movement in market rates.

The provision of variable rate loans effectively passes the
The financial organisation will ordinarily price its variable rate loan against a benchmark interest rate plus a margin. One such benchmark is the overnight cash rate provided by the RBA.

Financial organisations have an advantage with variable interest rates because as the cost of funds rise or fall, the lender can adjust the rate it is charging on its variable rate loans to suit.

For example, if the lender is required to increase the interest amount it pays to depositors from 4% to 5% in order to keep that business, then it will be inclined to increase the amount it charges borrowers on variable rates by an additional 1%.

**How do you choose?**

Whether to choose a fixed or variable rate can be a difficult decision. Generally a floating rate will cost less over the period as the borrower is avoiding the risk margins the lender will add to the rate. The borrower must also consider whether he/she can absorb increases in repayments from their current income.

Consider a couple with a home loan of $200,000. If the interest rate rose by 3%, it would mean an increase in repayments for borrowers on a variable rate of $6,000 per annum or $500 per month.

An astute borrower will be more inclined to borrow fixed when interest rates are low and variable when interest rates are high.