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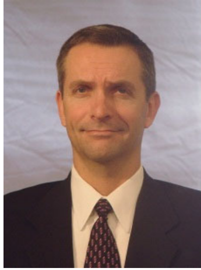
Corporate Federal Credit Union

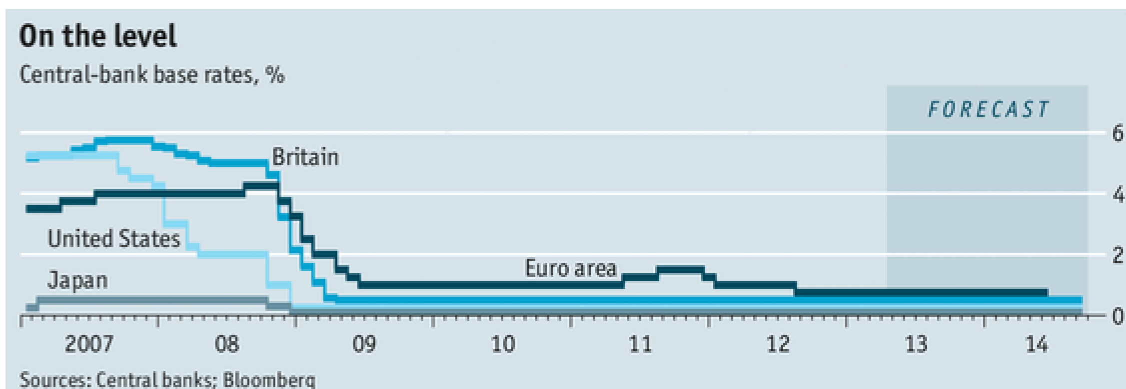
Fixed or Adjustable? The Age Old Question from a Different Viewpoint



By Tim Bruculere, Vice President, Lending and Loan Participations, Alloya Corporate FCU

We all probably think we have heard enough about interest rate risk lately. Recent regulations require many credit unions to have a written policy on interest rate risk (IRR) management and a program to implement it effectively. The news is filled with stories about historically low rates on mortgages and deposits. The 30-year fixed-rate mortgage rate hit several all-time lows at the end of 2012.

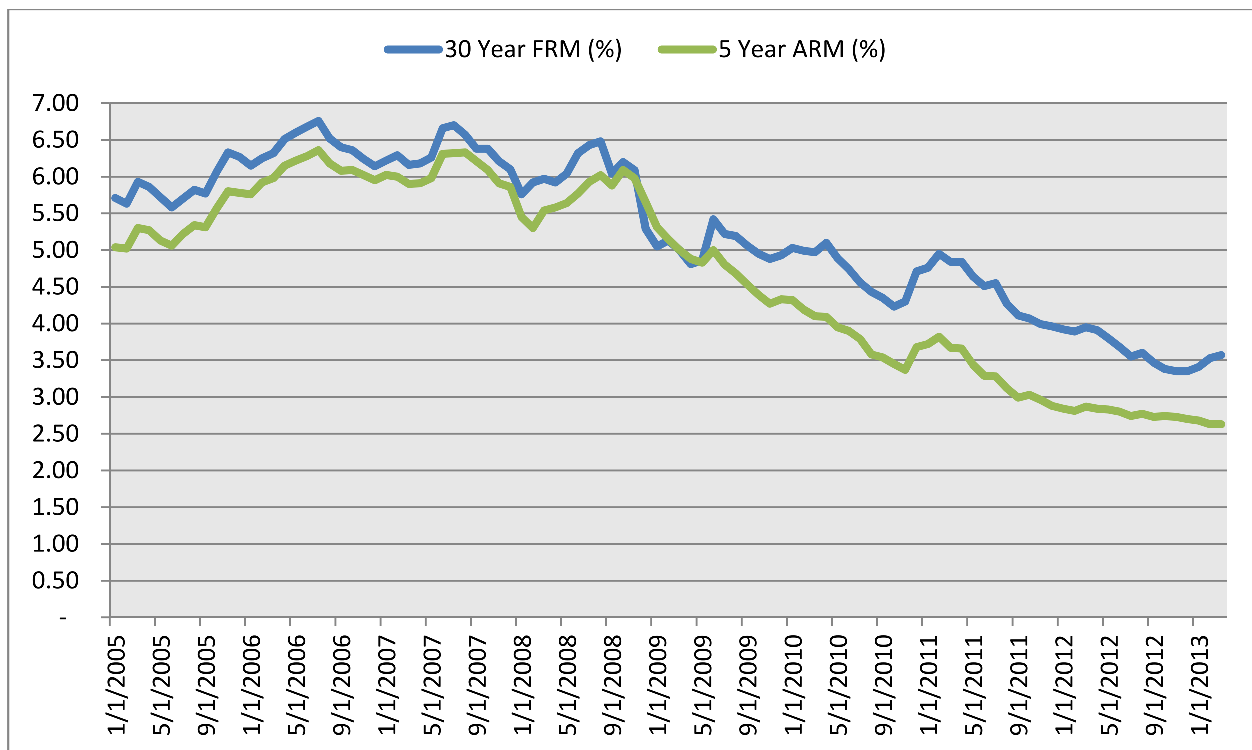
So why would you consider an adjustable rate loan when it's a virtual certainty that rates will eventually go up? As you can see from the following chart, using central bank data for the past six years and projected for the next 18 months, it's hard to go below zero.



Let's first consider the standpoint of the consumer. Since we are most familiar with mortgage rates, we will examine the factors that may help determine when an adjustable rate may make sense. Most of us take a 30-year fixed-rate mortgage because the rate is historically extremely low; the lower payments make our budget more affordable. When purchasing a house, those low payments allow for a more expensive home. In addition, budgeting is easier because you know what your mortgage payment will be for 30 years. Conversely, we have all read about how "teaser" mortgages with low initial rates that adjusted far beyond the ability of the homeowner to pay the larger payments. This was a main cause in the economic crisis of 2008-2009 and the subsequent economic doldrums.

Adjustable Rate – Two Factors to Consider

Factor one: The average consumer mortgage is paid, either from the sale of the house or refinance on the average of every five years. Factoring out refinancing, this number is around nine years. The number one question the consumer should ask is: *How long am I staying in the house?* With five, seven or 10-year adjustable rate loans available at lower rates compared to 30-year loans, it may be beneficial to borrow on an adjustable basis. For example, a homebuyer may be transferred to a new city and expect to remain there five years. A five-year adjustable rate loan can be obtained for an approximate rate of 2.65% (remember, that most "teaser" rate loans are no longer allowed, so that initial bump in rates is no longer a factor). Conversely, with a 30-year fixed-rate loan, your rate would be 3.50% with the adjustable options saving the consumer a considerable sum over those five years.



Source: Freddie Mac, Primary Mortgage Market Survey Archives

For your own credit union funding needs, are you borrowing for 90 days, six months, one year? The difference in spread for an adjustable rate loan over these time periods is 10 to 50 basis points. As we can see from the first chart, the forecasted interest rate environment is not predicted to change over that period, so an adjustable rate may save you interest expense. Additionally, unlike a consumer, credit unions have several funding sources available to repay the loan, should interest rates spike (deposits, another loan, REPOs, sale of securities).

Factor two: Most adjustable rate loans contain provisions limiting the amount that the interest rate can increase: both at the adjustment period and for the life of the loan, protecting the consumer from interest rate spikes. Even if the consumer spends an extended period in the home (beyond five years), these interest rate caps usually result in a manageable payment increase (remembering the interest and payments saved during the preceding five years). As indicated on the preceding chart, it is rare for interest rates to stay flat for any five-year period. In fact, an adjustable rate loan taken in 2009, when the Fed first reduced rates to near zero, would have provided an interest rate adjustment downward for the consumer.

For your credit union, unlike most fixed rate advances, most adjustable rate loans come with no prepayment penalty. And unlike consumer loans, loans to credit unions may be negotiated with interest rate caps or callable features – to lower the overall expense, while maintaining acceptable interest rate and liquidity risk to the credit union.

The analysis discussed here is in no way meant to indicate that an adjustable rate loan is always a good idea, either for the consumer or your credit union. However certain factors can help you make a better, more informed decision. So it appears that the answer to the age old question, "Fixed or adjustable?" is just what we would have expected: *It depends*. But at least now we know some of the factors influencing wise decisions and a few critical questions to ask. How long do I need the funds? Where do I think rates are headed? Am I protected against interest rate increases? Do I want to benefit if rates go down? What is the difference in spread between a fixed-rate and adjustable rate?

You should consider all these questions the next time your credit union needs funding, and consult your ALM manager or advisor to ensure that you are meeting all regulatory requirements.

Recognizing that rates never do what you expect, here is one final statistic to consider. Since the 30-year fixed-rate hit an all-time high in 1981, there has not been a five-year period during which an adjustable rate loan adjusted to a rate higher than the fixed rate at the time.

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