Opinion – Why variable rate mortgages are back on the table

There was a significant change in the mortgage and property market in 2022, which had up until recently seen mortgage interest rates hit record lows.

Here Michael Wales, a Mortgage Adviser at Progeny, explains why the old variable rate mortgage may now be a good option. The views in the article are entirely his, and the crucial advice is to get independent advice and remember that your home may be repossessed if you do not keep up repayments on a mortgage or other loans secured against it.

With soaring inflation, the Bank of England's only option to try and tame this has been to increase interest rates, recently hitting a height not seen for 14 years. For homebuyers, or those looking to remortgage, this has created a very different landscape from the one we've become accustomed to.

For the last ten plus years, a fixed rate mortgage product has been the most suitable option for many homebuyers. They were both the cheapest solution and provided peace of mind, in terms of knowing exactly what the monthly mortgage repayment would be.

As interest rates have increased however, products that have not seen much demand for over a decade – variable rate mortgages – have returned. You might ask: why would you tie yourself into a variable product when rates could increase in 2023? However, it’s important that homebuyers and owners reacquaint themselves with how these products work, to ensure they are considering the best solution for their circumstances and risk appetite.

What are variable rate products?

With a variable rate mortgage, the interest rate can go up or down in line with the Bank of England’s base rate, or your lender can set its own equivalent base rate.

The important difference therefore is that your monthly payments are not fixed, and you could end up paying more or less each month, depending on whether interest rates fall or rise.

There are three main types of variable rate mortgages: tracker rate mortgages, discount rate mortgages, and the standard variable rate.

Standard Variable Rate (SVR)

SVR products have an interest rate that is set by the lender. This rate is not directly linked to the Bank of England interest rate but in most cases this is the primary influence as to whether the SVR increases or decreases.

A lender can at any point increase or decrease their SVR, meaning that your payments can go up or down, making it more difficult to budget. The main benefit of a SVR product is the freedom to overpay by any amount or remortgage to a new lender without penalty.

SVR traditionally represents the highest rate that a mainstream lender will offer and is the product you will automatically fall onto once a fixed, tracker or discount rate comes to an end.

Tracker Rate

A tracker rate mortgage is a product that tracks the Bank of England (BOE) base interest rate to a certain percentage. For example, the current base rate is 3.5% and a lender then offers a tracker rate at 4% for two years. This means you are 'tracking' the BOE base rate at + 0.5% for that two-year period, with payments increasing or reducing accordingly.

Most lenders offer tracker products for a defined period, usually two to five years on an introductory rate, which is usually far cheaper than their SVR.

Discount Rate

A discount rate mortgage is a product that is linked to the lender's SVR, paying a reduced version of that rate for a defined period. The amount of discount is fixed and the reduction is applied whether their SVR increases or decreases.

For example, a lender has an SVR set at 6.99% and the discount rate you have is 4%. This means you have a fixed reduction of 2.99% for a defined period, usually two to five years.

Like the other variable rate products, any changes to the lender's SVR will result in fluctuating payments.

Considerations in the current climate

Fixed rate mortgage products, especially for five years' plus, are currently priced significantly higher than their variable rate counterparts. This is because mortgage lending and pricing is highly speculative.

Lenders consider the possibility or probability of the interest rate starting to fall in the next 12 – 18 months and want customers to fix at a higher rate, thereby gaining an advantage if the rate comes down. They currently offer the variable rates more cheaply, hedging their bets that the majority of customers take a more cautious approach and fix.

The big question for customers is whether they think that interest rates will increase enough to push their variable rate above the fixed rate that is available, or remain below it.

Help with decision making

Working out what is best can be tricky.

As a first port of call, an interest rate rise calculator is an excellent tool to illustrate the impact a rise would have on your monthly payments, to help you work out if you could afford it. Deciding on a new mortgage also presents an excellent opportunity get an accurate handle on your finances. A budgetary spring clean can help you identify any subscriptions that are no longer required or bills that could be reduced by changing providers.

Above all, a mortgage broker can help you understand all the available products that may suit your needs. They will also work with you to create an in-depth budget planner, to allow you to see what level of borrowing is possible, based on your net disposable income and will help you to properly assess your attitude to risk.

Whether you opt for a fixed rate or one of the variable rate options, seeking expert advice is has arguably never been more important in this current climate of volatility.

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