Home loans: Should you opt for fixed or floating interest rate?

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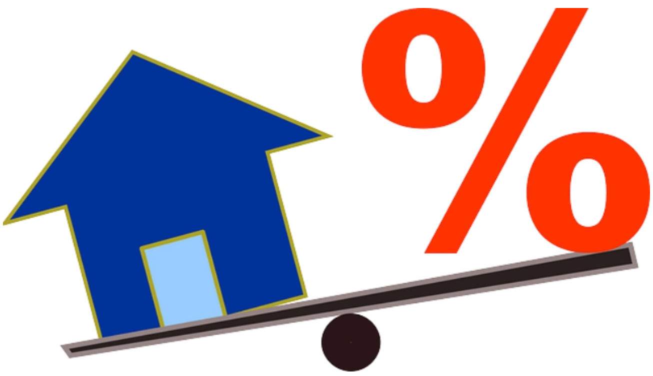
Noopur Praveen, August 6, 2021.



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The decision to choose between a floating and fixed rate of interest for a home loan has been an important one for borrowers. While floating rate means your current interest rate fluctuates basis the volatile economy, a fixed rate home loan will have a fixed interest rate irrespective of the external market changes. But even before you get into the dilemma of picking between these two options for a profitable future, another underlying alternative waits for your acknowledgment.

Apart from fixed and floating interest, there is sometimes an option of fixed-floating mentioned in the fine print. The 'fixed floating' rate loans are fixed for a particular period and then become floating. This may be helpful for borrowers in predicting their interest commitments for a certain period of time.

"Fixed loans may not necessarily be fixed for the entire tenor of the loan. Most lenders offer a semifixed loan, which remains fixed for 2-5 years, and then gets converted to a floating loan. Other lenders may offer a loan fixed for the tenor of the loan but may retain the option to revise the rate even periodically. So it is essential that you have a clear understanding of what "fixed" entails," said Adhil Shetty, CEO at BankBazaar.com.

Lender's perspective: Fixed vs floating interest rate

"In case of a fixed rate, the lender takes a judgment call on the expected movement of the repo rate for the next few years and decides upon a rate that will be an average of the expected rates. This ensures that the loan is profitable despite the movements in interest rate, especially if the repo rates start moving upwards. The floating interest rate, on the other hand, is a function of the bank's expense and margin with respect to the repo rate. While the interest fluctuates based on the repo, the margin remains the same," Shetty explained.

Typically fixed loan rates work well for lenders when interest rates are expected to head lower and therefore they can lock in loans at higher rates whilst they expect their borrowing costs to be lower going forward.

"With floating rate loans, there is a benefit of alignment on borrowing costs with the loan rates moving up with increases in interest rates in the economy and vice versa. However one needs to keep in mind that whilst loans like home loans are typically for very long periods, borrowings of lenders may be much shorter term and therefore exposed to the risk of interest rate movements in either direction," Vishal Dhawan, financial planner and founder at PlanAhead Wealth Advisors, said.

Borrower's perspective: Fixed vs floating interest rate

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according to Shetty, may offer a loan fixed for the tenor of the loan but may retain the option to revise the rate even periodically.
“So it is essential that you have a clear understanding of what “fixed” entails. Secondly, fixed loans come with prepayment penalties or charges. So, if your plan is to pre-pay your loan to close it earlier and save on interest, fixed home loans may turn out to be a more expensive proposition,” he said.

With the floating-rate loan, the interest rate keeps fluctuating depending on the market situation. This means that if there is a fall in the interest, it gets transferred the next time the rate is reset. On the flip side, when the interest rates are on the rise, the effects of the rise are transmitted even faster. However, it is also less expensive compared to the fixed or semi-fixed loans, making it a better alternative in the current situation where interest rates are stable.

“Apart from the interest rates, the chief attraction of floating-rate loans is the flexibility to make prepayments. However, every lender has its own terms and conditions around prepayments. So make sure you understand them clearly before going ahead,” Shetty added.

Typically in a period of low/falling interest rates, it is advisable to look at floating rates and when interest rates are headed downwards or flat, whilst fixed rates are better to consider when interest rates are headed upwards.

“However, since longer-term interest rates are difficult to predict, it may be best for borrowers to borrow for the shortest tenor possible basis their ability to service the loan EMI, so that the absolute amount of interest paid is kept low. In addition, they should consider keeping the EMI constant and reduce the tenor when loan rates reduce, rather than reducing the EMI when interest rates reduce. Similarly, when interest rates are headed upwards, borrowers should increase their EMI rather than increase tenor, so that interest costs are kept under control,” Dhawan advised.

What is the role of RBI?

Interest rates of credit products are linked to some benchmarks. This could be the repo rate or any other benchmark. The rates will vary as per the change in the benchmark.

“Primarily, this helps the transmission of rates. Any change to the benchmark will be reflected in the interest rates. So, as the rates go up and down, the interest rates will reflect this change. In a climate where the interest rates are steadily falling, the kind of responsive product is of great benefit to customers. Even when the interest rates are increasing, the consumer knows the percentage by which the increase will happen and can take measures to minimise the impact of the hike. This is unlike earlier when there was no clarity on how the transmission would actually happen,” Shetty explained.

As fresh home loans are largely linked to repo rate as RBI made it mandatory in October 2019 for lenders to link their home loan rates to an external benchmark, a lower repo rate or status quo on repo rate should enable borrowers to borrow at a lower cost or same cost, which helps keep interest costs down in an already low-interest-rate environment as we have currently.

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