Short duration nation

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High bond yields have spurred the US government into manoeuvres to contain debt-servicing costs. They also matter for the US mortgage market, where mortgages are mostly fixed-rate. Existing borrowers by definition do not face higher repayments when bond yields rise, but they can feel ‘trapped’ by the high cost of moving or refinancing.

The US model of 30-year fixed rate mortgages that are cheap to refinance is unlikely to be replicated in Australia. It only exists because of significant government intervention. Our tax, prudential regulation and superannuation systems also favour floating interest rates, even for loans with long contractual maturity like mortgages.

Long yields still matter for fiscal policy, and our corporate bond market is attractive to both domestic and offshore (Kangaroo) issuers and investors. But when thinking about financial conditions from a monetary policy perspective, the short end of the yield curve matters far more than in some countries.

Ten-year bond yields have breached 5% in Australia and the UK in recent weeks and are in the 4.6–4.8% range for US Treasuries, levels that have not been seen for some years. As discussed last week, this has spurred the US government to try to rearrange its finances to dampen yields. Its concerns go beyond the cost of servicing its own debt. In a mortgage market with predominantly fixed-rate loans, high bond yields drag mortgage rates up. Existing borrowers are insulated, but higher rates discourage moving, refinancing and home ownership. Demand for new homes is lower, weakening homebuilding activity, and some households feel ‘trapped’ by their current low mortgage rate. The cash-flow effects of monetary policy are therefore more concentrated on prospective borrowers and movers in a way that differs from Australia, where most mortgages reprice when the RBA tightens.

Some Australian observers see that relative insulation from interest rates and wish our system could be more like the US system. The reality is that the 30-year fixed-rate mortgage that is also cheap to refinance is almost unique to the US market and relies on a raft of expensive government interventions. From the government-sponsored entities (Fannie Mae, Freddie Mac, both still in government conservatorship, along with Ginnie Mae) to the network of Federal Home Loan Banks, the US mortgage market is built on an unusually large public infrastructure. Even other markets with shorter fixed terms sometimes rely on government interventions, such as Canada’s Canadian Mortgage and Housing Corporation insuring securitised loans.

Countries that intervene less in their mortgage markets mostly follow one of two patterns. Some, like Germany, offer fixed-rate mortgages, but refinancing or moving before the term expires involves expensive break fees, to compensate lenders for the interest rate risk. Borrowers cannot refinance cheaply into a lower rate when bond yields fall. The secondary markets for housing in these countries tend to be less liquid, and home ownership rates are often lower than in Australia – below 50% in the case of Germany.

The tax system favours it

The other model for mortgage markets is more like the Australian model, where loans have long terms but are mostly variable rate or only short-term fixes for 2–3 years. In Australia, this structure rests on a web of incentives for both households and financial institutions favouring that outcome.

For households, the main incentive comes from the tax system. For owner-occupiers at least, mortgage interest is not tax deductible, unlike in the US. Paying your mortgage out of post-tax income is a powerful incentive to pay it ahead of schedule. Doing so delivers a risk-free, post-tax return of the mortgage rate, which would be difficult to match elsewhere. The option of being able to pay ahead of schedule is therefore highly valuable to borrowers.

Because of the interest rate risk involved for lenders if the loan is fixed-rate, pre-payment is typically unavailable or at least limited for fixed-rate loans. This includes break fees on exit and limits on the payments into redraw facilities. The peculiarly Australian mortgage features of offset accounts and redraw facilities are rarely offered in countries where fixed-rate mortgages predominate. This means Australia's tax system encourages borrowers to value payment flexibility, which in turn favours variable-rate loans. Borrowers can insulate themselves from rate rises using pre-payment buffers, rather than needing a fixed interest rate to do this.

APRA incentivises it

The regulatory system also encourages variable-rate lending. Normally, banks are assumed to be in the business of "borrowing short" (e.g. deposits at call) and "lending long" (e.g. mortgages). Fixed rates normally include a term premium – a kind of insurance premium for the risk that funding rates move against the lender. By borrowing short and lending long, banks earn that spread as profit. This is a matter of interest rate risk: the effective maturity of at-call deposits is often very long, because people tend to stick with one bank for transactional banking for a while.

This strategy can occasionally blow up, however, if short rates (and so funding costs) rise above the average yield on one's assets. It can also blow up if the assets are bonds and other fixed-coupon assets that fall in value when long yields rise, as Silicon Valley Bank and other US banks found out the hard way a few years ago.

Australian banks are more protected from these risks because, unlike other regulators, APRA requires banks and other deposit-takers to hold capital against "interest rate risk in the banking book". Its "Pillar 1" approach is more prescriptive than the global Basel standards, which capture this risk in "Pillar 2", which is more about principles-based supervision rather than a capital requirement.

This changes the incentives for both lenders and borrowers. Instead of "borrowing short to lend long", Australian banks end up borrowing short to lend short: variable rate mortgages and three-month BBSW links for some other loans. A bank that funded long fixed-rate mortgages and business loans with floating-rate deposits, without an offsetting hedge, would incur more measured interest-rate risk and potentially a larger capital requirement.

The super system reinforces it

The design of the superannuation system also contributes to Australia being a short-duration nation. Almost all currently open superannuation funds in Australia are what is known as "defined contribution" (DC). Members contribute a pre-specified fraction of their wage, while the fund manager seeks the best returns, without guaranteeing outcomes. This structure favours allocation to equities rather than fixed-interest bonds, because on average their returns are higher (the "equity risk premium").

This model contrasts with “defined benefit” (DB) pensions, where there is an explicit promise of a post-retirement income stream based on some formula such as fraction of final salary. These types of pension systems are seen in some other advanced countries, and they imply a long-dated liability that needs to be matched, usually with fixed-interest assets. A DC system does not have the same type of liability, so it has less need to liability-match.

As a DC system matures and more people move into retirement phase, fixed-interest portfolios might become more important. For now, though, Australia’s superannuation system generates less demand for long-term fixed-interest assets than a DB system would. This does not prevent Australian borrowers from accessing long-term funding through global capital markets, but it does mean there is less natural domestic demand for long-duration fixed-interest assets

Central bank watchers need to remember it

For all these reasons, Australia is a ‘short duration nation’. Long yields still matter for asset valuations, hurdle rates, fiscal policy and some forms of private financing activity. Our corporate bond market is attractive to both domestic and offshore (Kangaroo) issuers. But organic domestic demand and supply for fixed interest securities is lower than in some countries. Long yields therefore matter less for monetary policy transmission and should receive less weight in considerations of financial conditions than in, say, the US or Japan.

A few conclusions arise from this difference. First, a US-style 30-year mortgage that is both fixed-rate and cheap to refinance is unlikely to become the norm in Australia.

Second, assessments of financial conditions can put more weight on the short end of the yield curve than the long end. In the US, people sometimes trip themselves up when bond yields move, thinking that this shifts financial conditions and means that the Federal Reserve does not have to move the policy rate to achieve the same effect. If yields moved because market participants expect the Fed to move the policy rate, though, things can get quite circular. Central banks can only use higher yields as a reason not to hike (or lower yields as a reason to hike) a few times before credibility suffers.

Third, it matters why yields have moved. For example, yields might fall because inflation expectations have fallen. The apparently looser financial conditions this implies do not need to be offset. The broader point is that the relationship between financial conditions and the policy rate is not mechanical. This was the lesson the Bank of Canada and Reserve Bank of New Zealand learned the hard way with their experiments with a Monetary Conditions Index in the 1990s, and that the RBA highlighted at the time. And in a short duration nation like Australia, that lesson needs to be remembered when thinking about financial conditions in the present day.

Browse topics

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