The case for variable-rate mortgages when rates are rising

IT'S BEEN A GREAT RIDE! Canadian homeowners have been benefiting from ultra-low interest rates over the last two years. Unfortunately the time has come: the rate climate is starting to heat up. As the Prime lending rate starts to gradually increase toward more normal lending rates of 5% to 6%, do variable-rate mortgages still make sense? Of course the answer depends on your own personal situation, but there are definite compelling reasons to choose variable.

Fixed-rate mortgages play a significant role with many Canadian homeowners, particularly those who may lose sleep wondering what will happen next with rates. Fixed mortgages are also ideal for those on a very tight budget; a fixed rate gives you the security of knowing exactly how much your mortgage will be so you can plan accordingly. Many first-time homebuyers choose a fixed-rate mortgage for this reason.

For those who are not on a tight budget, a variable-rate mortgage can be a wise financial move, even in a rising rate environment. Lenders offer variable-rate mortgages at the Prime lending rate minus a certain percentage, which varies by lender. So as the Prime rate increases, so will your mortgage payments. How fast Prime will increase will be determined by inflation and other key economic factors. Studies have shown that most Canadians hold their mortgage for 15 years or longer, and that over the long term, less overall interest is paid with a variable-rate mortgage. If you believe that minimizing the total amount of interest you pay over the life of your mortgage is an important goal, then the case for variable-rate mortgages is very strong.

The question to ask is: what do you want to pay right now – a lower variable rate, or a higher fixed rate? Prime rate increases tend to be gradual so it can take several Prime increases to reach current fixed rates. In the meantime, you can keep your savings for lifestyle, investments or to pay down your mortgage! Let's compare using today's rates for a $250,000 mortgage, assuming Prime increases 0.50% per year:

5-year Fixed-Rate Mortgage (3.69%)

Year	Monthly Payment	Balance	Interest Paid
1	$1,273	$244,021	$9,051
2	$1,273	$237,801	$8,819
3	$1,273	$231,331	$8,578
4	$1,273	$224,599	$8,329
5	$1,273	$217,597	$8,070

Total Paid: $76,380 **Total Interest: $42,847**

5-year Variable-Rate Mortgage (Prime -0.60%)

Year	Monthly Payment	Balance	Interest Paid
1 (2.40%)	$1,108	$242,600	$5,890
2 (2.90%)	$1,168	$235,483	$6,900
3 (3.40%)	$1,228	$228,591	$7,844
4 (3.90%)	$1,287	$221,868	$8,725
5 (4.40%)	$1,346	$215,263	$9,543

Total Paid: $73,644 **Total Interest: $38,902**

Difference in total payments	=	*$2,736*
Difference in interest paid	=	*$3,945*
Difference in total balance	=	*$2,334*
Total Savings		**$9,015**

In this case, choosing a variable-rate mortgage allows you to keep $9,015 over those five years, even though the Prime rate was rising. Of course, the Prime rate could increase faster than what has been used in this example. Since no one can accurately predict interest rate movements, your best bet is to have a good conversation with an experienced mortgage planner who can help you assess your own situation, and determine if a variable-rate mortgage is right for you.

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