Variable Or Fixed?

Getting Up Close And Personal With Your Mortgage

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I am a homeowner with a mortgage just like you, I have also been a Mortgage Broker for over 15 years… here is what I would consider when choosing my next mortgage.

We all know what the stats say, we hear it time and time again. Even our neighbour who has no experience with mortgages whatsoever is telling me that Variable Rate Mortgages (VRM) are the way to go! But I am not sold on it yet because what I know about a VRM is that my payments can change when the Bank of Canada prime rate increases and that rates could skyrocket as high as they were back in the early 80s at any time, and that scares the heck out of me! If I choose a VRM it is likely I will never sleep again!

Okay, we know that we should never make a decision, especially a financial decision, when feeling fearful or anxious. So instead of making a decision that is based on fear and anxiety, make a decision based on purpose. Let's break down all of the info you need to know so you can choose the right mortgage.

Generally the typical homeowner has two options when it comes to choosing a mortgage: Fixed and VRM (Variable Rate Mortgage). Here is what I would consider when choosing my next mortgage, in order of importance.

Rate And Market Trends?

The BOC indicated the following in its January 22, 2014 announcement:

- The Bank of Canada announced that it is maintaining its target for the overnight rate at one percent;
- Inflation in Canada has moved further below the two percent target. The path for inflation is now expected to be lower than previously anticipated for most of the projection period;
- The Bank expects inflation to return to the two percent target in about two years.

The above, in translation, ultimately says that inflation in Canada is below the BOC target. If inflation was at the preferred BOC target then there could be a reason to increase the BOC prime rate, albeit, since it is not then there is no pressure at this point to increase the prime rate. Also, the BOC has indicated that this is not expected to change for at least one to two years.

It is important to note that when the BOC refers to raising rates it is referring to the Prime Rate which is directly related to Variable Rate Mortgages. On the other side we have fixed rate mortgages which are controlled and priced by the bond market. These are two very different entities.

We know at this point in time that the BOC Prime Rate is expected to stay at 3% for the next one to two years. When comparing the current 5-Year Fixed Rate (as of March 28, 2014) which is currently 3.09% to the current 5-Year VRM at 2.50% (prime less .50%) there is a .59% rate differential between the two of them. So this means that the BOC prime rate would have to increase by .59% before the 5-Year VRM rate reaches the 5-Year Fixed rate of 3.09%. As mentioned, this is not expected for at least one or two years.

When taking this a step further, my calculations show that when comparing the 5-Year Fixed rate of 3.09% and the VRM rate of 2.50% (prime less .50%) over a five-year period, even if the BOC Prime Rate was to increase by .25% in months 18, 24, 36, 42, and 48 (which is equivalent to an increase of 1.25%), the VRM would still outperform the Fixed rate.

One last note regarding Rate and Market Trends, because this is the most important item to consider when choosing the right mortgage. I would like to give you an example of how Rate and Market Trends can affect your overall decision using a historical example. Last year the 5-Year Fixed rate dropped to an all-time low of 2.79% along with the 10-Year Fixed Rate of 3.59%. The VRM was at prime less .40% (2.60%) which was a differential of only .19% between the 5-Year Fixed and the 5-Year VRM. At that point I would strongly consider choosing the Fixed Rate as the spread between the two is equivalent to what an increase to the BOC Prime Rate would be. So if you chose a VRM at 2.60% and the BOC decided to increase their rate (which historically has been .25%), your rate would then be higher than the all-time low 5-Year Fixed rate of 2.79%. At that point in time the security and consistency of the 5-Year Fixed rate outweighed the option of the VRM. One last comment on this example: we now have determined that the Fixed Rate option certainly is the one to consider over the VRM at this point.

If we take this one step further then why not consider the 10-Year Fixed Rate option? Why? With 10-Year Fixed rate being offered at 3.59% this would provide a true "Inflation Hedge Strategy" against rising rates and certainly give you piece of mind knowing you will have the same payment for a very long time. In order to help make this decision I would then compare a 5-Year Fixed Rate of 2.79% with the expectation that in five years you would renew your rate at 4.75% (at that point in time the market forecast was for higher rates in five years which I still believe to be the case so I am preparing my clients for this). When comparing this scenario the 10-Year Fixed Rate outperformed the 5-Year Fixed Rate of 2.79% with your second 5-Year Fixed Rate term being at 4.75%. In fact, in this case you would have to renew your mortgage at 3.96% for your second five-year term in order to match the overall savings of the 10-Year Fixed Rate of 3.59%.

After reviewing the current available rate data and current market trends (as of March 28, 2014) the VRM should, by all means, outperform the Fixed Rate option over the next five years. Now that we know the VRM is expected to outperform a fixed rate mortgage, the next step is to break down the elements of a quality VRM product and how to best manage it. Believe me when I say, when comparing VRMs that are offered by Canadian mortgage lenders, they are not all the same: if you do not choose the right one you can end up with a product similar to a Ferrari or one similar to a rusted out Pinto that will only cause you grief and more money in the long run.

ARM Versus VRM

It is typical in the mortgage industry to refer to Variable Rate mortgages as VRMs as this is the most commonly known reference to these types of mortgages. However, there are two different versions of this mortgage, ARMs and VRMs. When comparing an ARM (Adjustable Rate Mortgage) to a VRM (Variable Rate Mortgage) there is a difference. Both will provide you with a rate that fluctuates with the BOC Prime Rate, which is not any surprise, so what is the difference?

The main difference is that with an ARM your payments will change when the Prime Rate changes so your current remaining amortization will not change. With the VRM your payments remain constant so if the Prime Rate changes, your amortization will increase (take longer to pay off your mortgage) because more of your payment will now be going to pay interest and not principal. With a VRM, if the prime rate increases, you can end up creating a negative amortization unless you manually contact your mortgage lender to increase your payments.

I recommend in this case being sure to choose an ARM as it is much easier to maintain. With this type of mortgage I would also consider using the "Inflation Hedge Strategy" which is a simple tool that will help you pay your mortgage off quicker and decrease your payment shock. Rates will eventually increase and the IHS is an effective way to keep you ahead of the rate curve. By simply increasing your payments every year over your term, you will get used to paying higher payments so if/when at the end of your term rates are higher it will not affect you as much because you will be used to making higher payments.

Monitor Rate And Market Trends

Watching and staying in tune with rate and market trends is important when you have a VRM. If this is not something that you like to do, are too busy to monitor yourself, have no idea what to watch out for, or simply feel like falling asleep whenever anyone brings up the topic (because we all know mortgages are not all that exciting), it is imperative that you find someone to deal with for your mortgage who will provide you with timely market info and how to evaluate this info, discuss your needs and wants both personally and financially, and most importantly be someone you can have an open discussion with. A mortgage lender's job does not end once your mortgage has been funded… it should be the beginning of a long-lasting relationship.

Converting To A Fixed Term From A VRM

If you choose the VRM route, you have the option to 'Lock-In' to a 'Fixed Rate' at any time without any cost to a term of five years or longer or whatever amount of time is remaining in your term. It is important to note that your 'Lock-In' rate with some lenders may have to be negotiated while others will provide you with a competitive 'discounted rate' without you having to spend the time stressing and negotiating. Choosing the right lender with all the 'deluxe' options is very important. Since you have the option to lock-in to Fixed Term at any time with a VRM, it provides you with the flexibility of enjoying a low rate while keeping an eye on the ever-changing Fixed Rates. If the Fixed Rates drop to a point that you feel will suit your needs and goals maybe it is time to lock in.

In conclusion, the VRM choice over a Fixed Rate is supported by current Rate and Market Trends. This info can change often and very quickly but if you make your mortgage choice based on the right info at least you have made a choice based on purpose. When I wrote this article I wanted to show homeowners that the difference between choosing a Fixed vs. VRM does not have to be difficult as long as you have the right info, so it is my hope that this article will help show you what to consider when choosing your next mortgage.

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