

# Why a fixed-rate mortgage may not be for you

**While the conservative nature of Canadians has made the five-year fixed-rate mortgage the most popular choice for purchasers across the country, the current low interest rate environment has prompted financial experts to promote variable-rate mortgages. Cindy Freiman tells you what you need to know to decide what's best for you**

Variable-rate products – especially adjustable-rate mortgages (ARMs) – have acquired a negative connotation in the past year due mainly to the sub-prime crisis that hit the US.

But ARMs are not what caused the most pain for our neighbours to the south – the way borrowers were qualified for these products is what led the mortgage market astray.

Essentially, borrowers qualified for ARMs based on low introductory teaser rates. When the rates adjusted to normal levels, however, these homeowners could not afford their ‘true’ monthly payments.

For affordability purposes, Canadian lenders qualify mortgage borrowers based on a three-year or five-year fixed interest rate, regardless of any introductory teasers – acting as a consumer safeguard.

## Why variable is better

Historically speaking, variable rates can save qualified borrowers from paying thousands of dollars of interest – with more of the payment instead going towards the principal balance of the mortgage – versus the fixed-rate option.

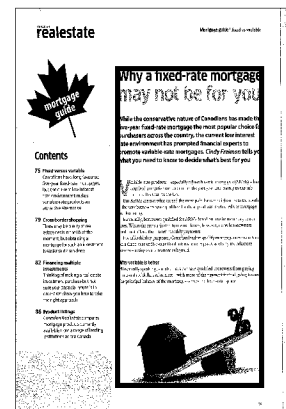
A study conducted by Moshe Arye Milevsky, *Mortgage Financing: Floating Your Way to Prosperity* – which examined interest rates from 1950 to 2000 – showed consumers are better off, on average, financing a mortgage with a short-term floating (prime) interest rate, compared to a long-term fixed rate, provided they can tolerate moderate fluctuations in monthly mortgage payments.

Milevsky, associate professor of finance at York University's Schulich

School of Business in Toronto, found that from 1950 to 2000, a consumer with a \$100,000 mortgage and a 15-year amortization would have paid approximately \$22,000 more in financing costs by borrowing and then renewing at the five-year rate, compared to borrowing at prime and renewing annually.

“We advise clients that there can be a fluctuation with variable rates – and this is based on historical numbers – of around 2%,” says Rob Regan-Pollock, a senior mortgage consultant with Invis based in Vancouver. This fluctuation depends on whether the Bank of Canada is experiencing an easing or a tightening trend.

Regan-Pollock predicts that Canadians should not expect to see a large fluctuation in rates over the next couple of years thanks to indications coming from our largest trading partner – the US.



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Date <b>31.12.2008</b>	Circ. <b>0</b>	Page <b>75</b>	<b>2 / 6</b>	

“The labour market is quite precarious in the US,” he says. “You’re looking at retail sales starting to soften and because retail values have suffered in the US, people aren’t able to use their house as an ATM any more and pull money out to keep themselves going.”

That being the case, the stimulus that kept the economy going has been removed, indicating that interest rates should remain stable or even decrease.

Greg Holohan, an investment executive and financial planner with ScotiaMcLeod, agrees, adding that Scotia Economics is predicting lower rates for the next two years, including a cut in rates of 50 basis points in early 2009.

#### **Well-qualified borrowers**

A purchaser with a gross debt service (GDS) ratio that falls within 25% to 28% is well-qualified for a variable-rate mortgage, says Regan-Pollock. GDS is calculated by adding annual mortgage and property taxes, then dividing that number by gross family income.

For instance, John and Mary have a monthly mortgage payment of \$1,200 (annual payment of \$14,400), property taxes of \$3,000 and a gross family income of \$60,000. This would give a GDS of 29% and they would qualify for a variable-rate mortgage.

Ideal candidates, however, also need to have very limited outside debt to enable them to easily withstand a 2% interest rate swing.

In order to further safeguard borrowers, many mortgage brokers suggest borrowers take a variable mortgage but make their payments based on a fixed mortgage.

As such, the rate of payment is set at a higher level – but still comfortable for a client’s budget – even though the mortgage is being administered at a lower rate. This is a great way to put more money towards the principal on your mortgage.

#### **Examining the risks**

Regan-Pollock’s biggest concern with variable rates is that unqualified borrowers are opting for these

mortgages because it’s the trendy thing to do.

“Borrowers should be taking variable rates because they’ve looked at where they are financially and what their budget is, and can easily afford the ups and downs,” he says. “Because they’re better-qualified and they’re not taking as much financial risk, they’re able to take a product with a bit more flexibility.”

If an unqualified borrower ends up with a variable-rate mortgage, they run the risk of having to lock in because they have zero budget tolerance, and they’re going to have to lock in at a negotiated rate with their lender.

Since most variable mortgages are available through a five-year closed contract, this could leave you at the mercy of your lender’s negotiated rate, which may not be even close to the average discounted rate available were you to commence your original mortgage term on that date.

For example, a standard five-year closed variable rate at the moment ranges from prime less 0.25 to prime less 0.60 – with prime currently at 4.75% – and this compares to an average lender’s negotiated lock-in rate of 6.15% (for example, 1% off the typical five-year posted rate). Conversely, a closed discounted mortgage rate with a five-year term currently ranges from 5.25% to 5.54%.

Regan-Pollock suggests inquiring with lenders on guaranteed lock-ins, which are terms set in writing that allow the client to convert from a variable-rate or an adjustable-rate mortgage to a fixed rate and receive the best discounted rate at that time. This makes taking a variable-rate mortgage a little less risky.

But John Bargis, president of Mortgage Edge, based in Richmond Hill, Ont., is not a fan of the guaranteed

lock-in rates because he says consumers pay for the guaranteed-rate privilege.

“If you really feel as though the rate is going to get to the stage of discomfort for you, then why not lock in a little earlier before the rate actually gets to the stage where you’ve got that cap?” he says.

### Locking in

Deciding when to lock in – or even *whether* to lock in – depends on a borrower’s level of risk tolerance.

“The very best mortgage brokers know who their clients are that have variable rates and are keeping them informed,” says Holohan, adding that most brokers send rate advisory e-mails and mailers to their variable-rate clients when rates are expected to change.

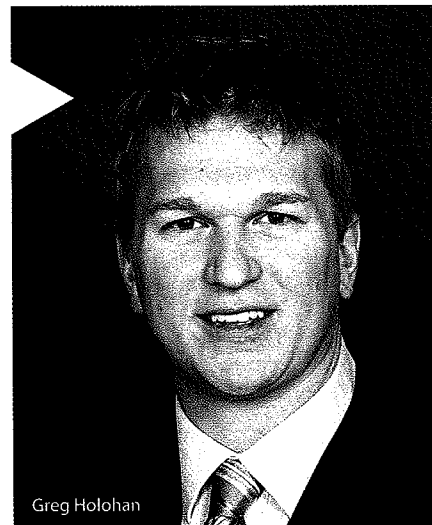
Both Regan-Pollock and Bargis keep their clients apprised of rate changes.

“Bond yields are the things to watch,” says Regan-Pollock. “If bond yields are going up, then chances are fixed rates are going to start going up. If bond yields are going down, which they have recently,

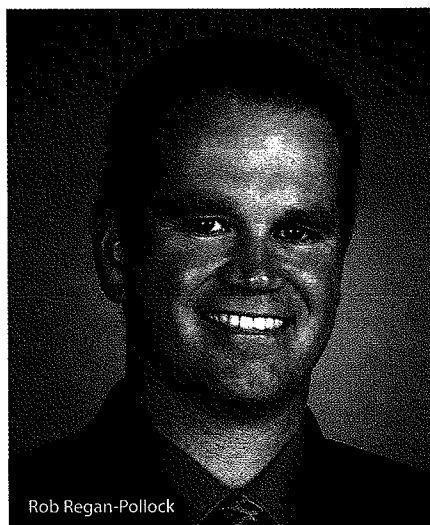
fixed rates are going to go down.”

Bargis looks at several different factors when advising his variable-rate clients, including: unemployment rate, housing starts, the resale market and economic conditions in the US, as well as globally.

To keep his variable-rate clients at ease, Bargis suggests they keep up with financial news so they know where the global market is heading. ■



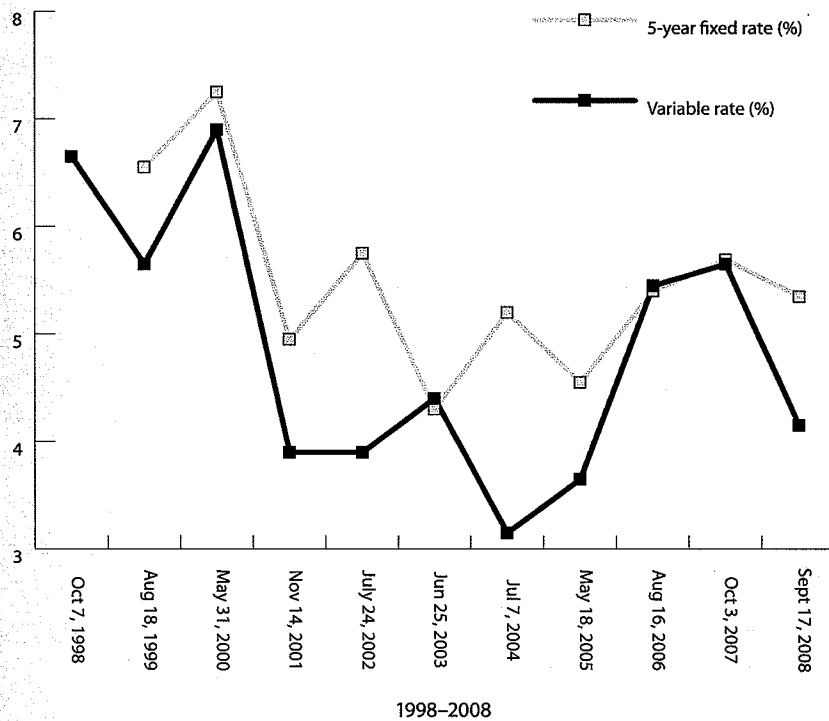
Greg Holohan



Rob Regan-Pollock

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**Variable rate vs 5-year fixed rate**



Source: CanEquity

**Cost benefits analysis of a variable-rate mortgage compared to a five-year fixed-rate mortgage**






The assumptions are:

- \$300,000 mortgage
- 25-year amortization
- Payments for both types of mortgages were set at a 5.45% rate (\$1,822/month)
- There is a 0.25% increase in prime per year
- Prime minus 0.60% adjustable rate offering for a five-year term

Savings indicated are over the five-year term based on the above assumptions.

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### Top variable-rate mortgage tips

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**Use a qualified mortgage broker.** Ensure your broker will watch the rate indicators for you and advise you of any important changes that could affect your payments.
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**Keep an eye on bond yields.** If bond yields are going up, chances are, fixed rates are going to start increasing. On the flip side, if bond yields are going down, which they have been recently, fixed rates are going to decline. Variable rates are a lagging indicator, so they will not rise or fall until after prime and fixed rates have been affected.
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**Will your payments adjust or remain the same if prime changes?** The concern here is that there are some variable-rate products that remain the same, regardless of prime, while others adjust at monthly or quarterly intervals. If they don't adjust, there's the possibility that you could put yourself into an interest-only or negative-amortization situation.
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**Look at rate guarantees.** If you find yourself in a situation where you may need to lock into a fixed rate, does your lender offer a guaranteed discounted rate or will you be at the mercy of the lender to negotiate a rate? Do you have to pay extra for the guaranteed-rate option?
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**Learn the variable-rate definitions.** Ensure your mortgage broker explains the difference between a front-loaded (teaser), adjustable and variable-rate mortgage. If they aren't willing to educate you, opt for another opinion.

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