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Which option is best for your situation, a fixed or variable rate?

When the time comes to choose your mortgage term, there are a number of elements to take into account, including your financial means, your risk tolerance and the economic situation. To make the best possible decision, here's some information that will help you in selecting your mortgage type.

Fixed versus variable rate: which is lower?

Variable-rate mortgages tend to be lower than fixed-rates. To understand the difference, you need to look at how these rates are calculated. Essentially, a financial institution's variable interest rate corresponds to its preferential rate. This is established based on the Bank of Canada's overnight rate. Add a certain percentage to this, and you have the variable rate.

As with fixed-rate mortgages, the monthly payment amount usually stays the same, but the ratio of interest to principal is subject to market fluctuations. There are also certain types of variable-rate mortgages where the monthly payment varies based on the fluctuation of market interest rates. With a fixed-rate mortgage, you are guaranteed to always have the same amount dedicated to repaying your principal, regardless of what the market does.

What creates variations in mortgage rates?

Mortgage rates fluctuate based on the Bank of Canada overnight rate. The prime rate represents the target overnight rate based on which most financial institutions borrow and lend money amongst themselves over the course of a day. Eight times per year, the Bank of Canada announces its intention to raise, drop or maintain the prime rate.

Following a rise in the prime rate, financial institutions generally raise mortgage rates, though not always. This won't impact fixed-rate mortgage holders much until the end of the term, however variable-rate mortgage holders will feel the change almost instantly. It's important to remember that this impact isn't restricted to mortgages; it also affects savings accounts, credit lines and other financial products.

Rate hikes and your budget

An increase in the prime rate and, consequently, in mortgage rates, isn't necessarily a catastrophe. It all depends on several factors. For example, if the prime rate goes up by 0.25%, the impact on variable-rate mortgages is minimal. If you had a $300,000 mortgage, the increase would translate to about $36 more a month. Hardly enough to break your budget.

The situation can be far more severe if you have a variable-rate mortgage though, and your initial loan exceeds the limits of your budget.

Faced with relatively low borrowing rates and the possibility that rates will drop even further in the short term, some buyers have been able or might be tempted to buy a property that stretches the limits of their purchasing power. Then, if interest rates go up, they find themselves in a bad financial position.

To make sure that you aren't adversely affected by increases, make your monthly mortgage payments based on the fixed rate. Your mortgage repayment will be accelerated and at the time when the variable rate equals the fixed rate, the margin will leave you enough time to decide if you want to go from variable to fixed. As with all things concerning money, the golden rule comes back to respecting your financial means when you buy a house.

Is it possible for the variable rate to equal the fixed rate?

Though rare, it is possible for the variable rate to equal or even surpass the fixed rate. However, it depends mainly on the economic situation. Many observers and actors in the economic sphere agree that the variable rate is usually much more advantageous.

In many of his studies, York University finance professor Moshe Milevsky analysed the cost of a five-year, fixed-rate mortgage in relation to a variable-rate mortgage over the same term, between 1950 and 2000. The results showed that borrowers who took fixed-rate mortgages over five years paid more interest. The author also highlighted the fact that one-year terms, both fixed and variable, were more financially beneficial to borrowers.

As with any financial product that fluctuates with the market, it's important to factor your tolerance to risk into your decision-making.

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