# The Rate Debate: Fixed or Variable?

In my Mortgage Brokerage business, I am privileged to serve a wide variety of clients that represent a multitude of age ranges and situations.

Out of all of the questions they ask, the most common one is: "Should I get a fixed or variable rate?"

Their question to me is really about which kind of rate will save them the most money, and my answer back is always about their risk tolerance and lifestyle.

Just as property is usually most people's biggest asset, a mortgage is usually their biggest liability. Where people might have a high risk tolerance when it comes to investing $10,000, it might shift considerably when they think about a mortgage of $300,000.

Here are 3 steps to help you choose the right rate type for you:

## STEP ONE: Understand what choices others have made

Here's what Canadians are currently doing with regards to fixed and variable rate mortgages:

- 68% of Canadians get a fixed rate mortgage
- 27% of Canadians get a variable rate mortgage
- 5% of Canadians hold combination mortgages (fixed and variable rates)

## STEP TWO: Understand yourself

Ask yourself the following questions when considering which rate type is best for you:

1. What is my current risk tolerance with my existing investments (low, medium or high)?

2. Does my risk tolerance change with a significantly larger amount of money (my mortgage)?

3. Despite the length of my term (such as 5 years), how long will I realistically be in this mortgage for?

4. If I choose a variable rate, how willing am I to check the market on a regular basis to keep on top of upcoming changes?

5. How important is it to me to have a regular budget for my mortgage payments, so that I know exactly what I owe each month?

6. If I choose a variable rate, am I prepared to lock in to a fixed rate at a higher premium or at a time when fixed rates are higher than they are today?

If you loose sleep worrying about the possibility of a .25% increase in the interest rate, or experience anxiety thinking about the impact on your monthly budget if your mortgage payment changes, then a fixed rate mortgage is for you.

Simply put: If your risk tolerance is low and the thought of security brings you joy, then a fixed rate mortgage is probably better for you.

On the other hand, variable rates have historically performed well for people in terms of saving money. Based on a detailed study of interest rates from 1950 to 2000 completed by Moshe Arye Milevsky, consumers are better off, on average, financing a mortgage with a short term floating (prime) interest rate, compared to a long term fixed rate mortgage. A consumer with a $100,000 mortgage and an amortization period of 15 years would have paid $22,000 more in interest payments by borrowing and then renewing at the 5 year rate as opposed to borrowing at prime and renewing annually.

Simply put: If your risk tolerance is higher and you enjoy being less conservative, then a variable rate mortgage might be better for you.

**The bottom line: Peace of mind is priceless. Figure out what you need to achieve this with regards to your mortgage, and then make choices accordingly.**

## STEP THREE: Research

### Fixed rate vs. Variable: Mortgage: To fix or to float?

Banks expected to get stingier with discounts

**By Gary Marr, Financial Post** Published: Saturday, January 26, 2008

Would you borrow money from someone if they could change the rate of interest whenever they wanted to?

About 20% of Canadians signing up for new mortgages have been doing just that. One out of every five new mortgages is now a variable rate product tied to prime. Prime is dictated by your bank.

As rates tumbled during this housing cycle, consumers worried about locking into long-term mortgages. The fear of being shut out of the latest rate cut from the Bank of Canada had consumers looking to products with floating interest rates.

Generally, when the central bank cuts rates, your interest rate comes down. But as the global credit crisis has widened, one big question is whether the banks will continue to lower prime with every cut from the country's central bank.

So far, the answer is a clear yes. The major banks went along with a 25 basis cut from the Bank of Canada this past week and lowered their prime lending rate for customers from 6% to 5.75%.

"The word on the street has been that maybe they wouldn't drop," says Don Lawby, chief executive of Century 21 Canada Ltd.

Whether the banks continue to pass on Bank of Canada cuts probably will not change demand for variable rate products, he predicts. One of the reasons he does not think consumers should or will panic is that they always have the option of locking in their rate on a variable rate product.

Most variable rate products sold by the banks include an option that allows you to fix your rate for the remaining term of your mortgage--albeit at a slightly higher rate than you might normally achieve if you did not have a mortgage contract.

"The issue will always be, 'is the rate I can negotiate for one, two, three or five years better than my current variable rate or not?' That's the decision the consumer is going to make. If consumers think rates are going up, they lock in," says Mr. Lawby.

But the truth is, floating rate mortgages have been rising for months but it has been happening in such a subtle way few people have noticed. A year ago, a consumer could borrow money at 90 basis points off prime. Anybody with that type of deal is now paying 4.85% interest based on the latest cut.

Unfortunately, if you are borrowing today, credit availability has tightened. As the banks' costs have increased, their profits have narrowed. To deal with the shortfall they cut the discount offered to 50 basis points off prime.

Essentially, they have balked at the Bank of Canada rate cut by cutting the discount. That same variable rate mortgage today will be at 5.25% interest.

Given the shrinking discount and the uncertainty of the banks going along with future rate cuts, does it make sense to continue to have a floating interest rate on your mortgage?

Moshe Milvesky, a professor at York University's Schulich School of Business, wrote the now widely disseminated study on whether it made sense to lock in your mortgage rate. In the study which looked at decades of interest data, he found consumers did better 88% of the time with a floating rate mortgage.

"It's the other direction that worries me. If the Bank of Canada lowers rates and they raise prime or the banks arbitrarily raise prime ... that's more worrisome because of unpredictably," says Mr. Milvesky.

He predicts the banks will probably just get stingier with the discounts they offer rather than not passing along Bank of Canada rate cuts. They can knock the discount down to 10 basis points and few people will get upset, says Mr. Milvesky.

Ultimately, he does not see a sudden rush to fixed rate mortgages but it will open the eyes of consumers. "It makes them aware of the fact that it is the bank that controls their interest rate, not the Bank of Canada," says Mr. Milvesky.