With low interest rates, is it time to reconsider your mortgage?

Are variables a good idea?

By Fiona Anderson, Vancouver Sun July 27, 2010

VANCOUVER - With mortgage rates low and more likely to go up than down, some borrowers may want to think long and hard about whether they want a long and hard — fixed, that is — mortgage rate.

The first question is whether to go fixed or variable when borrowing to buy a home. Statistics show that 88 per cent of the time, a variable mortgage is cheaper than a fixed-rate mortgage, said Feisal Panjwani, senior mortgage consultant with Invis-Feisal & Associates Mortgage Consulting in Cloverdale. But the problem with a variable rate is that it is just that: It changes over the life of the mortgage.

The variable rate is based on the lender's prime lending rate, which today is 2.75 per cent for the major banks and credit unions. The best variable rate available according to Invis — a national brokerage company who negotiates mortgages on behalf of clients with various lenders including banks, credit unions and wholesale lenders — is prime less 0.6 percentage points, or 2.15 per cent. But banks change their prime rate from time to time, usually whenever the Bank of Canada changes its overnight target rate, which it has done twice since the beginning of June and is expected to do again in the fall.

Lenders also change the formula by which they calculate the variable rate. So while the best variable rate is now prime less 0.6, earlier this month, before the Bank of Canada's most recent hike, the rate was prime less 0.5 per cent. That means people who took out a mortgage two weeks ago would be paying 2.25 per cent (2.75 minus 0.5) now. In October 2008, when the Bank of Canada's rate was at an all-time low and credit was tight, lenders were charging as much as prime plus 1.0 for their variable mortgages and borrowers who signed up then would be paying 3.75 per cent now.

If that kind of uncertainty "is going to keep you up at night," Panjwani recommends taking a fixed rate.

"Lock it in and forget about it," Panjwani said.

If you are willing to take the risk, check your payments, he said. Some mortgages will adjust the monthly payment every

time the rate changes, making it difficult to budget. Others will keep the payments the same but just attribute more to interest and less to principal if rates go up (and vice versa if they go down).

The next question is how long to go. Except for six-month mortgages, rates are generally higher the longer the term. But if you think the rates are going to go up, you may want to lock in longer and preserve the rate you can get now.

The most common term for fixed-rate mortgages is five years, but with rates at historic lows, Barry Rathburn, manager of mobile mortgage specialists with TD Canada Trust on Vancouver Island, believes some people might want to look at a 10-year mortgage.

The 25-year average for the five-year rate is more than eight per cent, but the 10-year rate now is as low as 5.35 per cent, Rathburn said.

So for those on a fixed income, or employed in a job that isn't likely to see much of a pay increase over time, knowing what your payments will be for 10 years may be a source of comfort, he said.

It also makes long-term budgeting easier, he added.

Panjwani agrees that a 10-year mortgage might be suitable for someone who is very risk-averse and wants to lock in a low rate for as long as possible. But statistics show that only 10 per cent of the time has a 10-year term worked out better than two consecutive five-year terms, he said.

And while the 25-year average for a five-year posted rate is more than eight per cent, most lenders offer a discount of at least one percentage point from their posted rates, so the average is closer to seven per cent. And that average includes the extremely high rates of the late 1980s.

But if you did want a long-term mortgage, "historically speaking now is a good time to do it," Panjwani said.

However, he said, you will be paying a premium — the difference between the 10-year and five-year rates, which now are as low as 4.29 per cent.

"So there's a quite a big premium you're paying to take the extra five years of security," he said.

But if rates do increase significantly, then "those taking a fixed 10-year are going to be ahead of the game."

And no one knows for sure what will happen to rates, he added.

"In my opinion, unless someone is extremely concerned about rate fluctuations, they are better off on a five-year," Panjwani said. "But for those people who really want to play it safe, it's okay."

One thing a 10-year borrower doesn't have to worry about is a larger prepayment penalty. As discussed in last week's Money Watch, lenders usually charge the greater of three months' interest or interest differential — the difference between the interest on the mortgage being paid out and the rate the banks could earn re-lending that money — when a borrower wants to pay out his mortgage before the term is up.

If this applied to 10-year mortgages, that interest rate differential could be quite high. But a Canadian law, which has been around for more than 100 years, limits the prepayment penalty for any mortgage that is greater than five years to three months' interest, said David Mydske, the national practice group leader for the commercial real estate group at Borden Ladner Gervais LLP.

So the interest differential may apply for the first five years, like a five-year term, but after that the lender can charge only the three months' interest, Mydske said.

With rates likely rising over the next few years "that's probably all [the lender] is going to get anyway," he said. "So I'm not sure it's as big an issue now when rates are so low."

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