

The Mortgage Minute

Rising Rates – Should I Lock In?

With the recent upswing in interest rates, there is a tendency for those who are currently in a variable rate mortgage to rush out and lock in to the best 5 year rate available today. And if you are a new homebuyer (especially first time homebuyer) the prevailing logic is to choose a long term fixed rate mortgage for the comfort and security that it provides in times of uncertainty. In fact, there is so much talk about locking in these days it makes me wonder if maybe that's exactly what the banks want us to think.

The argument put forward by those who prefer floating with the Prime rate is that anyone who has taken the variable rate mortgage over the fixed rate mortgage has been further ahead 88% of the time over the last 20 to 30 years. That begs the question; now that we have just come out of a period of historically low rates as a result of the global recession – are we now in that '12%' period of time where it makes sense to choose a fixed rate?

Well, I decided to do some math of my own and play around with some numbers to try and separate the truth from the hype and the results were interesting. At the time of writing, the Prime rate was 3% and the best 5 year rate mortgage was 4.05%. A recent report by RBC suggested that Prime would go up by 1% by the end of 2011 and they anticipated a further 1.5% increase by the end of 2012. This is in line with what many analysts and economists are predicting. Now, I could go on about why I personally believe that any increase in the Prime rate will slow down our economic recovery and that until the US and global economies start to show signs of sustained growth the bank of Canada will be limited in terms of how much they can raise rates – not to mention the impact on the Canadian dollar from higher rates – but alas, that is fodder for a separate debate.

So, instead of arguing about whether or not I believe rates will go up, I'm going to assume that the Prime rate in Canada will double to 6% over the next 5 years. I then compared a client with a \$300,000 mortgage and 25 year amortization who locked in today for a 5 year mortgage at 4.05 to a client who chose to float in a variable rate at Prime minus 0.60%. The key here though is that I kept the monthly payments the same for both clients and compared where they were at the end of the five years. The results were surprising.

The client who chose to stay floating at Prime minus 0.60% over the five year period ended up saving just under \$5,000, even though their interest rate at the end of the five year term was 5.4%.

So what does this tell us? The average interest rate for the variable ended up being around 3.7% over the five year period. The reason for this is a fundamental key to all mortgages. You pay the bulk of the interest up front. So what this analysis shows us is that having a lower interest rate in the first few years but choosing to make a higher payment has the effect of accelerating your debt reduction to the point that it is still more economical to remain floating – even if the Prime rate were to double.

Here are two key points to make:

1. Every time you choose to lock into a long term interest rate; you are in effect, choosing to pay a higher rate as an insurance premium against future rate hikes. This gives you peace and comfort knowing you never have to worry about where rates are going.
2. Some may suggest that there is no guarantee that rates won't go up even higher than a Prime at 6%. This is true, nothing is guaranteed. Therefore it is extremely important to maintain perspective over the following months when we start to read the headlines that will be talking about rising rates and potential housing bubbles. Today's rates are still at historical lows. So if you have any concerns about where rates are going, or you simply don't want to take a chance – lock your mortgage into a 5, 6 or even a 10 year rate and sleep well. Even if rates took off and the housing market dips, if you are locked in and can afford your mortgage payment, simply ride out the market and wait for prices to rebound and rates to fall in time for your mortgage to come up for renewal.

There is no right or wrong answer when it comes to whether you should float or lock in. For my money, I'll continue to float and focus on reducing as much debt as I can over the next five years. But remember, I always say the definition of a bad investment is the one that keeps you up at night. So if you're having trouble sleeping – lock in your rate today.

Happy Investing,

Peter Kinch