What's Better for You? Fixed-Rate Mortgages vs Variable-Rate Mortgages

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For first-time home-buyers, choosing the right mortgage can feel daunting. Here's a classic example: Let's say Jen and Jon Smith are taking the plunge with a three-bedroom, two-bath detached home in a mid-size Alberta city. But when it comes to their mortgage, they're not sure which way to go between a fixed rate or variable rate mortgage. Which mortgage is right for them? What are the pros and cons? How do costs differ? The questions go on and on, and the short answer of "it depends" isn't exactly comforting.

To make the best possible decision, the Smiths need to educate themselves about mortgage products and their short- and long-term impact on their finances, real estate and lifestyle and discuss the pros and cons with their mortgage broker and financial advisor.

Mortgages in 2019

"As mortgage brokers, we need to understand their current family, career, lifestyle and financial circumstances and consider their future plans and goals," says Vancouver-based Rob Regan-Pollock, senior mortgage broker, Invis Inc., and co-chair of the Canadian Mortgage Brokers Association. "Of course, the short- and long-term financial cost of the mortgage is important, but they also need to look at their risk tolerance and need for flexibility since most Canadians move every 3.7 years or so."

Fixed-Rate Mortgage Benefits

Across Canada, up to 70% of consumers are committing to fixed-rate rather than variable-rate mortgages. Right now the fixed rate, often 3% or less, is the cheaper option. Importantly, it also offers absolute predictability and peace-of-mind.

As Tracy Valko, a Mortgage Professionals of Canada director and the owner of mortgage brokerage Dominion Lending Centres Valko Financial Ltd., explains it, a fixed rate mortgage is a fully amortized mortgage loan with a set interest rate. As a result, mortgage payments remain exactly the same, whether Jen and Jon are paying $842.85 every week for five years or $4,962.25 every month for three years. If they break the mortgage term early, the penalty will be three months of interest (their fixed rate) or an Interest Rate Differential fee (the difference between the lender's original interest rate and their current interest rate) – whichever is greater.

"Fixed rates are great for homeowners who need financial certainty and stable costs and expect to stay in that home for the length of their mortgage term," says Wes Sudsbury, mortgage broker, Homeguard Funding, Newmarket, Ont. and president of the Canadian Mortgage Brokers Association's Ontario Chapter's board of directors. "Variable rates are better if they suspect they may sell or refinance before their mortgage term is up."

Variable-Rate Flexibility

Variable interest rates fluctuate with changes to the Prime Lending Rate, which is determined by the Bank of Canada's decisions regarding the overnight rate eight times a year or every 6.5 weeks. Until recently, a variable rate mortgage typically cost less than a fixed rate mortgage and homeowners paid lower penalties than if they were to break a fixed mortgage term. As interest rates change, regular payments will fluctuate with the lender adjusting the amount allotted to the principal and interest.

"You're better off with a fixed rate, if you're going to worry every time the Bank of Canada meets about the overnight rate," says Sudsbury.

Playing the Mortgage Market

Mortgage experts know that life is unpredictable. A family that had no intention of moving before their mortgage term ends may need to relocate or refinance if circumstances change, for example, a pregnancy, a promotion or job loss, divorce or unexpected expenses.

While geography has no effect whatsoever on mortgage rates, local real estate markets may influence homeowners' propensity to stay put or sell. If prices are dropping or rising rapidly as happened in Vancouver and Toronto very recently, they may be motivated to make a

change and break their mortgage term early. Variable rate mortgages typically carry only a three-month simple interest penalty, which makes them a generally superior product for people who may need to break their mortgage term early.

“Homeowners that are more speculative and have an aggressive plan to climb the real estate ladder may be better off with a variable rate so they can more cost-effectively capitalize on the equity they’ve built,” says Regan-Pollock.

Homeowners with variable rate mortgages can lock in, but the fixed rate they pay will be based on current market conditions. They’ll also have to lock in for a term of equal or greater length than the term remaining on their variable mortgage. Many homeowners are shocked when they discover they can’t lock in at their current variable rate or choose the term.

Fixed-Rate or Variable-Rate?

When debating the pros and cons of fixed and variable rate mortgages, home buyers need to discuss several key factors with their mortgage brokers and financial advisors:

1. How will penalties be charged? Lenders don’t calculate penalties to break a mortgage contract the same way. Make sure you understand the costs you’ll incur if you exit before maturity.

2. Does the mortgage include restrictions such as prohibiting the transfer of the mortgage to another property to avoid penalties or banning a mid-term refinance with another institution?

3. Can the homeowner obtain a payout or discharge statement if they are refinancing, and not selling their home? To keep homeowners until the end of the term, some ultra-low mortgage products contain clauses that let you break the mortgage only if the home is sold.

Jon and Jen’s unique life, financial, family and career circumstances will help them decide whether a fixed-or variable-rate mortgage makes the best sense for them. But they’re fictional - when it comes to real life, it’s important to do the research, crunch the numbers, and figure out what type of mortgage will put your mind at ease.

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