Understanding fixed and variable mortgages

And the impact of rising rates on each

Your mortgage is an important part of your financial plan. Based on a recent study, it is the second largest single expense, behind taxes, for a Canadian household.[1] Therefore, when choosing which mortgage is right for you, it is important that you are well-informed on the different options.

One key option to consider is whether to select a fixed or variable mortgage. Each comes with its own set of features and benefits.

	FIXED	VARIABLE
How Does It Work?	Interest rate and mortgage payment will remain the same throughout your term.	Mortgage payments will stay the same, however the portion of that payment that is used to pay interest will change if there is movement in the prime rate.
Benefits	1. Predictability: because your rate doesn't change, the amount you pay towards interest and principal doesn't change either. 2. Security: your fixed rate is locked in for the duration of your term, so when interest rates rise, you can take comfort knowing your rate won't change. 3. Confidence: you'll know exactly how much of your principal will be paid down.	1. Lower interest: interest rates for variable mortgages historically tend to be lower than fixed. 2. Benefit from declining rates: should the prime rate decrease, so would your interest rate, and more of your payment would go toward principal. 3. Flexibility: you can convert to a fixed-rate mortgage at any time. 4. Lower break fee: if you sell your home, the prepayment charge for a variable rate mortgage will always equal three months worth of interest, generally resulting in a lower charge than for fixed.
Considerations	1. Higher rate: the initial rate is often higher than that of a variable mortgage. 2. Higher prepayment charge: if you break your mortgage the charge will likely be higher than a variable-rate mortgage.	1. Risk of rising rates: should the prime rate increase, less of your payment will go towards the principal of your mortgage.

[1]Frasier Institute. Taxes versus the Necessities of Life: The Canadian Consumer Tax Index 2021 edition.

Factoring in changing interest rates

The expected interest rate environment over the term of your mortgage should be considered when choosing between a fixed or variable mortgage. With interest rates near all-time lows, and with inflation becoming more of a concern, the likelihood that the Bank of Canada will raise its policy rate in the near term is quite high.

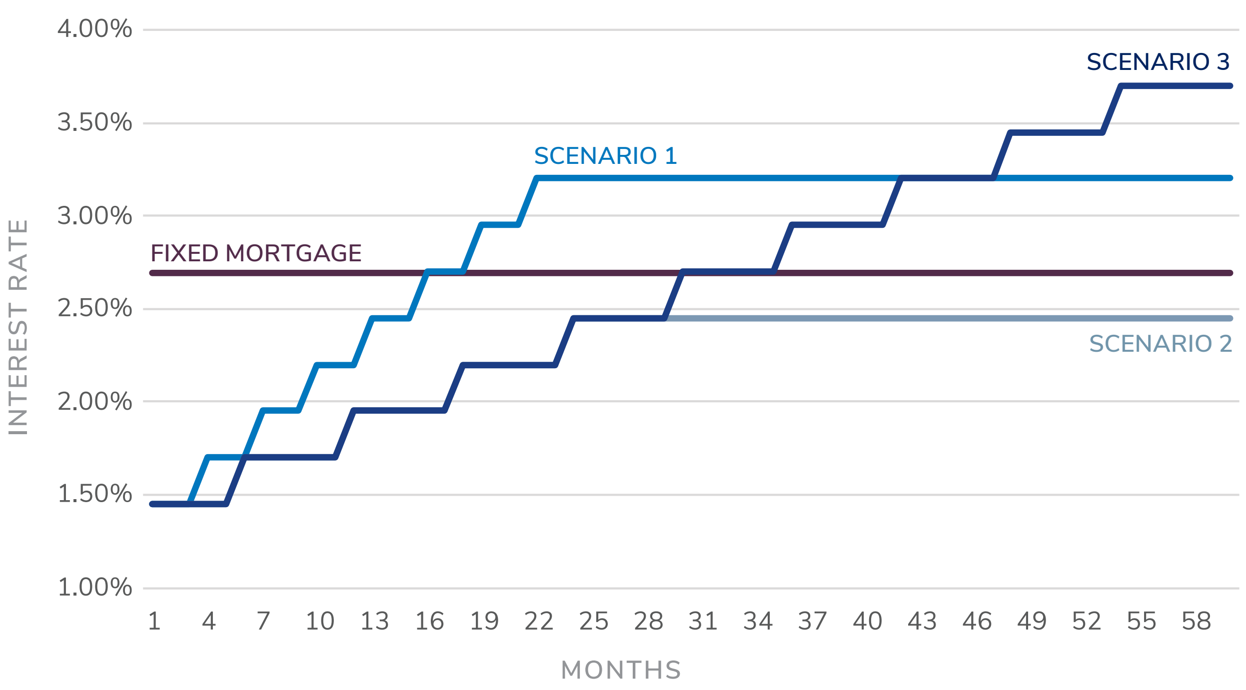
However, rising interest rates may not be enough to choose a fixed mortgage over variable. Other factors need to be considered: your life situation and any potential future changes; your comfort level with risk; and how each option would fit within your overall financial plan. Additionally, how much and for how long are rates expected to rise should also be considered, as they will affect how much of your mortgage payment will be paid towards your principal versus interest.

To help better understand the impact, below is a hypothetical comparison of a fixed 2.69% rate mortgage against a variable 1.45% rate mortgage under three interest rate scenarios:

SCENARIO 1 Rates rise 0.25% every quarter for seven quarters over the next two years, for a total increase of 1.75%.

SCENARIO 2 Rates rise 0.25% every six months over the next two years, for a total increase of 1%.

SCENARIO 3 Rates rise 0.25% every six months over the next five years, for a total increase of 2.5%.



Assumptions used for hypothetical scenarios: $500,000 mortgage, 5-year term, over a 25-year amortization period. Fixed rate mortgage principal and interest payments are based on beginning balance and kept constant for the 5-year term. Variable rate mortgage principal and interest payments are calculated monthly based on previous months balance.

	TOTAL PAID	TO INTEREST	TO PRINCIPAL
FIXED MORTGAGE	$138,000	$62,362	$75,638
SCENARIO 1 Variable, 0.25% rise per quarter, for seven quarters over 2 years.	$138,000	$65,361	$72,639
SCENARIO 2 Variable, 0.25% increase every 6 months for the first 2 years	$138,000	$50,138	$87,862
SCENARIO 3 Variable, 0.25% increase every 6 months for 5 years	$138,000	$60,094	$77,906

Conclusion

Choosing between a fixed or variable mortgage will depend on various factors, such as your current and expected future situation, comfort level with the different options, and your overall financial plan. And of course, interest rates and whether they are expected to rise.

It's not just how much interest rates could rise, but also how quickly they rise, that should be factored into your decision. Looking at the hypotheticals in this piece, in Scenario 1 rates rose quickly and became higher than the fixed rate mortgage. The result was less paid towards the principal comparatively because the interest rate was higher than the fixed rate for a longer period. Scenario 2 saw rates rise modestly and gradually, resulting in the highest principal payment. Although interest rates in Scenario 3 rose to a much higher level than the fixed rate mortgage, more of the principal was paid off because the increase was gradual.

Your mortgage is one of the largest expenses for your household, and your home is likely to be your largest asset. Choosing which mortgage is right for you is an important decision. At IG Wealth Management we offer a variety of mortgage solutions that may be a good fit for your financial plan.

Talk to your IG Consultant who, together with a Mortgage Planning Specialist, will review your options and find the right solution for you.