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Food for Thought

A moment's insight is sometimes worth a life's experience.

- Oliver Wendall Holms Sr.

REAL ESTATE SMARTS

Million Dollar Question: "With Mortgage Interest Rates likely to rise in the future, should one choose a fixed or a variable rate mortgage?"

Basically, the choice between a fixed rate mortgage and a variable rate mortgage will depend on the following two factors:

a. Estimated forecast of the interest rate increases in the future years.

Recent reports by the major banks have forecast that the key interest rate increase by the Bank of Canada will not come until July 2013 or early 2014 that will translate into commensurate increases in the variable mortgage interest rates. However, for the purpose of estimating the order of magnitude of interest savings involved in a 5 year closed mortgage, I am considering the two scenarios. The best case with 0% increase over 5 years and the possibility of 0.5 % increase every year starting January 2014.

b. Borrowers' level of "Risk Tolerance" while considering a variable rate mortgage.

Choosing the variable rate mortgage involves a certain level of risk. The borrower can end up paying a higher interest amount if the interest rate increases are larger than initially anticipated. Is this possibility going to keep the borrower awake at night?

The following table shows a comparison of the fixed rate mortgage with the two scenarios stated above. The 5 year fixed rate mortgage is at 3.09% interest rate with 25 year amortization The variable rate used is Prime minus 0.5% i.e. 2.50%. The monthly payment is set at \$ 955. These mortgage rates are being offered by Anderson Financial. The criterion for loss or gain is the Principal Balance at the end of the term.

| OPTION LOAN TERM | 5 YR CLOSED INTEREST RATE START OF TERM | PROJECTED INTEREST RATE CHANGE | REMAINING PRINCIPAL BALANCE ON \$200,000 AT THE END OF THE |
|------------------------|---|--------------------------------------|--|
| Fixed Rate | 3.09% | n/a | \$ 171,244 |
| Variable Rate | 2.50% | 0% increase | \$ 169,320 |
| Variable Rate | 2.50% | 2% increase | \$ 175,048 |

We see that there is a saving of \$1,924 if the current variable interest rate of .25% remains unchanged over the term. If the interest rate increases by 2% over the term the loss will be \$ 3,804. These calculations are done only for illustration and I recommend that you have your lender advise you on your specific circumstances and needs.