Stability comes at low price

Floating rate higher than a 5-year term

James Daw
Money Talk

Home buyers seeking a mortgage these days can get the best of both worlds: select the lowest interest rate around and still lock it up for the next five years.

"We've got pretty much a flat interest-rate curve," says Scott Plaskett, a certified financial planner with Ironshield Financial Planning in Toronto.

"So it takes the whole issue of whether to lock in or take a variable rate out of the equation," at least for first-time buyers.

Look around and you will find lenders charging as little as 5 per cent interest for the next five years. For just half a percentage point more, you can get a whole decade of stability.

Meanwhile, those same lenders would charge you slightly more for a variable rate. This is an odd but recurring situation seen in only about a quarter of the months in the past decade.

The current advantage enjoyed by long-term mortgages is not likely to persist, economists warn. So, a floating rate could still provide borrowers some savings for an extended period.

Yet, despite repeated predictions that short-term rates are about to fall, the savings from a floating-rate mortgage might not be apparent for several months to come.

According to last month's federal budget, the consensus of economists in Canada is that short-term rates will remain stable this year and next.

➤ Please see **Daw, F7**

54% say they'll choose a fixed rate in future

➤ **Daw** From F1

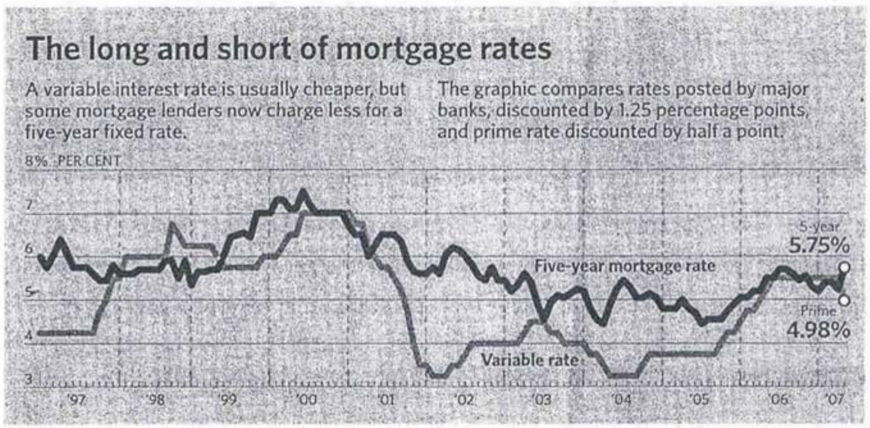
When and if interest savings do emerge for variable or floating-rate mortgages, average savings over a five-year term are unlikely to be as large as they have been historically.

One frequently cited study by Toronto finance professor Moshe Milevsky reported that, from 1950 to 2000, the average saving from a floating-rate mortgage would have been $22,000 on a $100,000 mortgage paid out over 15 years, and much more in some periods.

At one point in the early 1980s, short-term mortgage rates were more than 20 per cent, and five-year rates of 15 per cent looked like the bargain price, although not for long.

When Manulife Financial released Milevsky's research, he did not foresee such large savings from floating-rate mortgages in the future as he had found the past. Interest rates have fallen back to the levels of the 1950s, and central banks seem better able to control inflation, with the help of low-wage competition from China and India.

Milevsky's prediction of reduced savings from floating rates was later reinforced in a study by economist Ali Manouchehri of Canada Mortgage and Housing Corp.



Milevsky had used figures from the Bank of Canada, the only reliable source of historical figures. But Manouchehri pointed out that these figures, based on the rates posted by banks, are no longer representative of the marketplace.

Thanks to the work of mortgage brokers, a new breed of small, aggressive lenders, and to savvy consumers, even the big banks offer steep discounts. This has further pared the potential savings from taking a floating rate.

Take a homeowner given the choice of paying 1.25 percentage points less than a bank's posted rate for a fixed five-year mortgage, or a floating rate at half a point less than the prime business lending rate.

Short-term mortgages were more than 20% in the early 1980s, and five-year rates of 15% looked like a bargain

The difference, on average over the past decade, would have been 0.77 of a percentage point from month to month.

On a $100,000 mortgage paid monthly, that difference would work out to savings of about $7,150 over 15 years, or $13,370 over 25 years. That's more per year than recent tax cuts for families, but not overwhelmingly persuasive.

Small wonder, then, that Ipsos Reid pollsters found in January that 54 per cent of borrowers intend to choose a fixed interest rate in future, in most cases five years or longer.

Only 13 per cent planned to choose a completely variable rate. A sizeable portion of respondents — 38 per cent — said they planned to hedge their bets by choosing a mortgage that has a blend of a fixed and variable rate.

Those preferring variable rates could have their resolve tested, though. Ted Carmichael and colleagues at J. P. Morgan Securities Canada Inc. are among a minority of economists who think the Bank of Canada could raise rates as much as a percentage point to head off inflationary pressures.

"We think the economy has some resilience," Carmichael says. "Inflation has picked up, and central banks remain concerned about it. If inflation goes higher, we could see a second leg of tightening happen."

Carmichael released a brief commentary recently in which he argued the Bank of Canada may need to raise short-term interest rates if it is to keep inflation at 2 per cent or less.

"We may be moving into an environment where it is not as clearly advantageous to go with a floating rate," he said, although there should still be savings over a five-year period.

Financial planner Scott Plaskett says he urges clients to keep their over-all financial plans in mind when making the choice between a fixed and floating rate.

"My advice to first-time buyers would be to go long, insulate themselves from fluctuations and let the dust settle," he said.

One of his clients found it advantageous to pay the penalty to break an existing mortgage in order to lock in at today's low rates.

But those with more cash, and the ability to reduce their debt aggressively, are probably best to choose a short or floating rate, Plaskett says.

The opportunity to repay additional debt when rates float lower would offer a decent return, although paying mortgage debt can rank third in how to spend your money, behind getting a tax deduction for contributing to a retirement savings plan, and getting a 20 per cent grant for contributing to a registered education savings plan, he said.

"Your objective should be to accumulate net worth in as fast a way as possible."

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