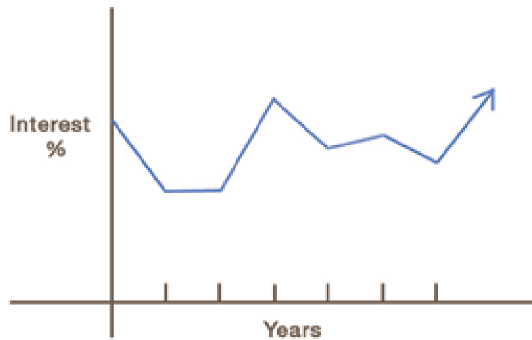

Understanding Variable Interest Rate Mortgages

What is a variable interest rate mortgage?

A variable interest rate mortgage is a mortgage loan with an interest rate that can change during the term. The interest rate varies with changes in market interest rates (typically the bank's prime lending rate). The mortgage payments can be fixed, or they could change if the interest rate changes – it depends on the lender and type of product.

What are the benefits?

If market interest rates are stable or go down during your term, you could pay less in interest than with a fixed interest rate mortgage. By the end of your term, it is possible that you could have paid more toward your principal than expected and less towards interest, which would reduce the balance owing and shorten the time needed to pay off your mortgage.

What are the risks?

If market interest rates go up during your term, your interest rate would increase and you would pay more in interest to the lender. As a result, by the end of the term, you might have paid more in interest than if you had chosen a fixed interest rate mortgage. It also means that by the end of your term, you might pay less of the principal than expected, which would lengthen the time needed to pay off the mortgage.

Depending on the lender and the terms of the variable rate mortgage, another risk is that your payment could increase if the interest rates increase. Consider how much of an increase in mortgage payments you could handle. If you don't think you can handle the risk of your mortgage payment increasing, or do not have enough cash flow, you may be better off with a fixed interest rate mortgage. On the next page, you can see an example of how interest rate changes can affect a mortgage.

What makes variable interest rate mortgages attractive?

The interest rates on variable rate mortgages are often lower than the fixed interest rate offered at the time you sign the contract. However, whether you are better off with a variable interest rate mortgage compared to a fixed interest rate mortgage depends on the movement of market interest rates during the life of your mortgage, called the "term." This movement is difficult to predict. For example, between 2000 and 2009, the Bank of Canada Bank Rate varied from 0.5% to 6.00%[1].

What happens to mortgage payments when interest rates change?

When interest rates change, depending on the lender and the terms of your mortgage, the following scenarios are possible:

1) Your payment goes up or down each time market interest rates change.
2) Your payment stays the same when market interest rates go down, but increases when market interest rates go up. In this scenario, more of your payment goes toward paying down the principal when the interest rate falls.
3) Your payment does not change unless market interest rates increase to a "trigger" point (shown in your mortgage agreement). Only at that point will the lender increase your payment.

Example:

John takes a mortgage with a variable interest rate and the following terms and conditions:

- ***principal amount borrowed***: $200,000
- ***term (length of the mortgage agreement)***: 5 years
- ***amortization period***: 25 years
- ***interest rate***: variable, initially set at 3.00%
- ***monthly payment***: variable.

The lender explains to John that his payments will go up and down with the interest rates.

At first, John's interest rate is stable at 3.00%. Starting in the second year, market interest rates begin to climb and so do his payments.

[1] Source: Bank of Canada, Bank Rate (V122530).

	Interest rate[1]	Monthly payment	Interest paid	Principal paid
Year 1	Initial interest rate: 3.00%	$946	$5,889	$5,469
Year 2	rises to 3.50%	$997	$6,676	$5,285
Year 3	rises to 4.00%	$1,046	$7,415	$5,143
Year 4	rises to 4.50%	$1,096	$8,106	$5,041
Year 5	rises to 5.00%	$1,144	$8,749	$4,978
TOTAL	–	–	**$36,835**	**$25,916**

[1] In this scenario, interest rate changes happen at the beginning of the year.

In this example, the interest rate goes up 2.00% over the five-year term. Keep in mind that interest rates could go up or down more or less than 2.00% over that period, and those changes would affect calculations.

John's alternative at the time was a five-year fixed-rate mortgage. In the example below, the bank offered him a fixed rate of 4.00% for five years.

	Interest rate	Monthly payment	Interest paid	Principal paid
Years 1 to 5	4.00%	$1,052	**$37,230**	**$25,892**

In this scenario, after five years the amount of interest and the amount of principal John paid with a fixed or variable rate mortgage would be almost the same. The main difference is that with a variable rate mortgage, John's monthly payments would change from year to year, but with a fixed interest rate John would know that his payments would stay the same for the full five-year term.

Protecting yourself against a rise in interest rates

Some lenders offer *interest rate caps or convertibility features* on their mortgages. These features can offer some protection if interest rates go up. You can only get these features when you sign a new mortgage agreement that includes them.

A *cap* is the maximum interest rate that can be charged on a mortgage, regardless of the rise in market interest rates. For these types of mortgages, usually the payment amount is based on the cap rate and will stay the same for the term.

If you have a mortgage with a *convertibility feature*, you can change it to a fixed interest rate mortgage during the term. Although the lender will usually not charge a penalty for doing this, conditions may apply – check with the lender.

Questions to ask a mortgage lender

- How often could my payments change – each time the interest changes, or on what other basis?
- If the interest rate goes up by 1.00% during the term of my mortgage, how much would my payments increase based on my current mortgage balance? If the rate increased by 2.00%, how much would my payments increase?
- If my interest rate increases, can I choose to increase my payment so that the length of time to pay off my mortgage stays the same?
- Are there any conditions under which the payments would stay the same? For example, is there a minimum interest rate increase required to trigger an increase in my mortgage payments?
- If there is a "trigger" interest rate, how would I be notified of the increase in mortgage payments?
- Do you offer mortgages with interest rate caps or convertibility features? What are the conditions of using these features?

For more information

For more information on variable interest rate mortgages, visit FCAC's website (fcac.gc.ca) or contact your financial institution.

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