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Fixed or Variable Mortgage Rate? BMO Experts Offer Their Verdict

TORONTO, Ontario, February 01, 2010 — With interest rates at a record low, a growing number of people are looking to purchase a home. Every homebuyer faces the age-old question of whether to choose a fixed or variable rate mortgage.

“The question of whether to lock in to a longer-term fixed mortgage rate or stay in a variable rate has become an increasingly complex and important debate,” said Doug Porter, Deputy Chief Economist, BMO Capital Markets. “Short-term rates are at historic lows and pressure is likely to build for higher rates in the year ahead.”

Research shows that over the past 30 years it has been more cost-effective for borrowers to have a variable rate mortgage 82 per cent of the time. However, under the current environment, Porter points out there are a number of factors to consider before assuming the variable rate is the hands-down winner:

- Canada has been in a long-term declining rate environment since the early 1980s.
- The Bank of Canada’s overnight rate is now as low as it can go, so there is no further downside for variable rates. The surprises can only be to the high side from here.
- Fixed rates were advantageous during only two recent periods – through the late 1970s and in the late 1980s; in both cases ahead of a period of rising interest rates, as is the case now.

The Case for Staying Fixed

A conventional fixed rate mortgage can mitigate a number of risks. Although inflation has not been a problem since 1991, there is a risk of an inflation flare-up as global central banks keep the pedal to the policy metal, and amid record government deficits. The Bank of Canada could be forced to raise interest rates aggressively, driving variable mortgage rates higher, but leaving Canadians with fixed rates relatively unscathed. Plus, fixed rates are currently very attractive given that short-term rates are already as low as they can go.

The Case for Going Variable

The advantage to a variable rate mortgage is that it has been consistently less costly over time. As well, the current outlook for inflation remains benign, which will likely keep price pressures at bay well into 2011. The soaring Canadian dollar is putting additional downward pressure on prices, reducing the near-term need for the Bank of Canada to raise rates. There is also some risk to locking in as fixed rates could fall if the economy performs worse than anticipated. Even as rates start to rise, Canadians can always lock into a fixed rate at a later date.

The Verdict

The decision depends on the individual. For those who do not have a lot of financial flexibility – such as first-time home buyers and those who would run into difficulty from an upswing in interest rates – the moderate extra cost of peace of mind you can get from a fixed rate may be a price worth paying. There is also a reasonable scenario where fixed rates may actually prove to be a cheaper alternative at this point. That’s particularly the case given some recent cuts in long-term fixed rates, such as BMO’s current special rate of 4.09 per cent for a five-year fixed mortgage. BMO Economics’ view is that variable rates will climb only moderately, but by enough to tilt the balance in favour of current fixed rates.

“The most important thing a current or first-time homeowner can do is talk to a knowledgeable mortgage expert about their situation and make decisions based on their particular circumstances,” said Jane Yuen, Senior Manager, Mortgages, BMO Bank of Montreal. “So come in to a branch or contact a mortgage expert to decide on the type of mortgage that is best for you at this point in your life.”