

Variable Rate Mortgage (VRM) vs. Fixed rate Mortgages

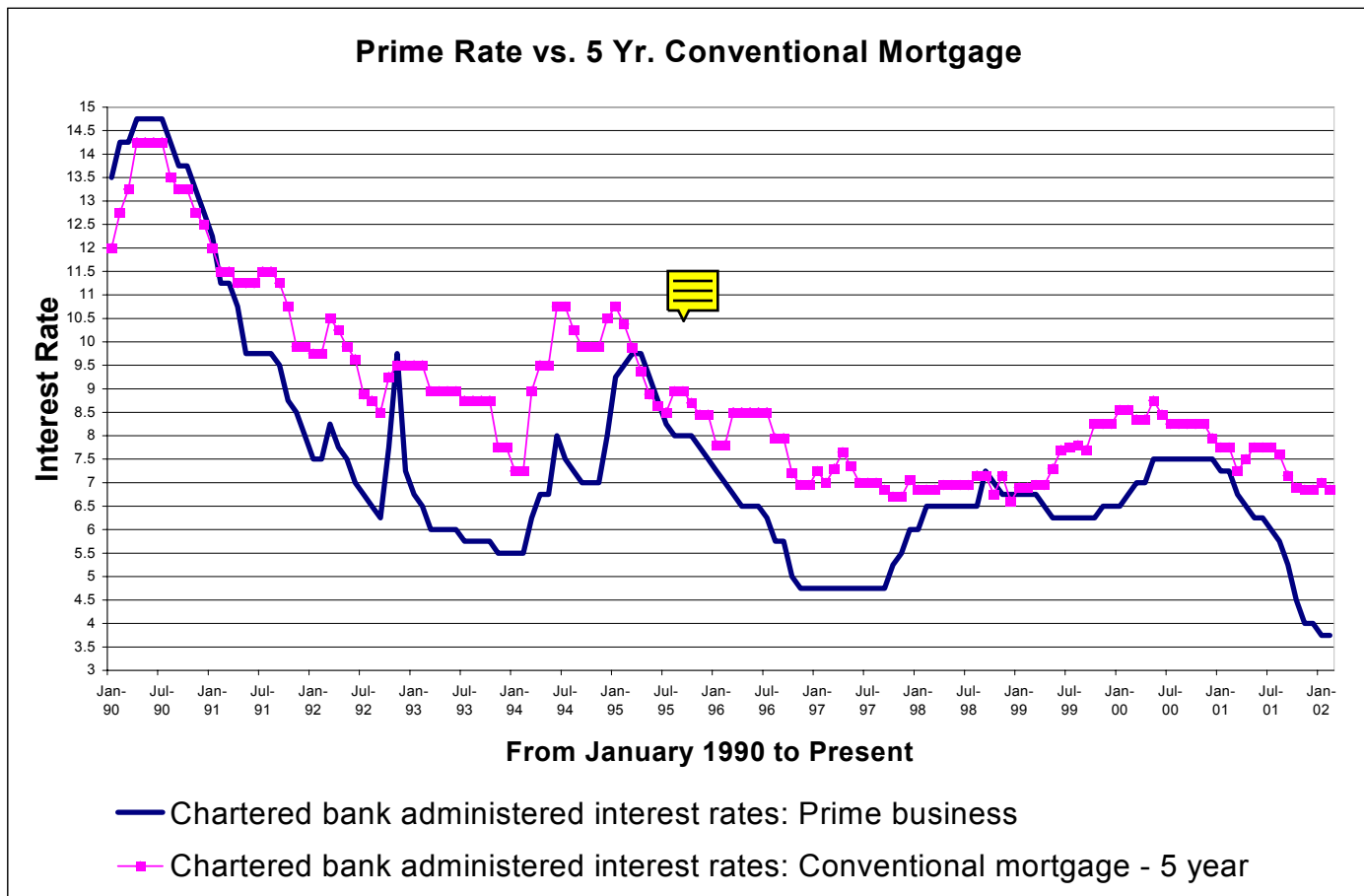
Q: HOW ARE INTEREST RATES SET ON A VRM VS. A FIXED RATE MORTGAGE?

Fixed Rate: Lending institutions go to the **highly volatile bond market** (fluctuates based on political and economic conditions) to finance their mortgage lending on fixed rate mortgages. The **rates are set based on the yield in the bond market** at any given point in time. For example, if a \$100,000 bond falls in value to \$95,000, the corresponding yield (return) is significantly higher. Because the yield is higher, **the prevailing interest rate that is set for the mortgage must offset the higher yield** and provide a return on the mortgage for the lending institution. Therefore, the rates on fixed rate mortgages would tend to rise in such cases.

VRM: VRM **rates are set based on adding a premium to the Bank of Canada rate.** This is now called Bank Prime rate. The Bank of Canada uses the bank rate to control inflation in the economy. In low inflationary times or times of economic recession, the Bank of Canada rate tends to be very stable with a bias to move to the low side. Currently the Bank Prime rate is 4.50%.

Q: HISTORICALLY, HAVE MORTGAGORS BENEFITED BY TAKING A VRM VS. A FIXED RATE MORTGAGE?

YES!



The graph on the previous page compares the Bank Prime rate to the fixed 5-year rate from January 1990 to Feb 28, 2002. The solid line represents the Bank Prime rate. As you can see, if the consumer chose a VRM rate over a Fixed rate at any time over this period, even when the VRM was higher, within a short period the VRM rate moved below the prevailing 5 year rate. If the monthly payment was set at the same amount as would be the payment for a 5 year fixed, the result would be a shorter amortization period – i.e. same monthly payment, but lower outstanding balance at the end of the term.

Q: WHY SHOULD I CONSIDER TAKING A VRM vs. A FIXED RATE MORTGAGE TODAY?

Based on today's prime rate of 3.75%, many lenders are offering even further discounted mortgages, some as low as **.75%** below prime or **3.00%**. The Bank of Canada rate forecast indicates that we may see some upward movement in rates towards the latter part of this year. Some economists suggest a gradual increase of perhaps 1 – 1.25% by year's end. Assuming that is the case, when you add that increase to a discounted VRM rate of 3.00% your effective rate is **4.25%**, far below the current, lowest discounted five year fixed rate of approximately 6.00%.

To attain the true benefit of the lower effective rate of 3.00% or even 4.25% to take years off the life of the mortgage, one should make payments on a VRM, based on what the payment would be as if they had taken out a mortgage at 6.00%. The savings at the end of the term will surprise you.

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