

SAVING THOUSANDS

by making sense of mortgage terms

By Peter Kinch



In a recent discussion with a client, the question of “fixed” versus “variable” mortgages came up. She wanted to go with an “open variable” rate mortgage, which surprised me because they are often more expensive. When I asked why she wanted to pay more for the option of having her mortgage “open,” she replied, “Well, aren’t all variable-rate mortgages ‘open?’” I realized then that what was obvious to me isn’t necessarily so to everyone else. How many Canadians make the same mistake and end up paying a premium for a feature they’ll never take advantage of?

Most Canadians are not mortgage experts, and the various terms that bankers and brokers throw about can be confusing. Fixed, open, closed, variable – as if you’re supposed to understand everything and make a choice in five minutes on the biggest ticket item you’re likely to ever commit to.

So, what are the terms and what do they mean?

The two basic mortgage options are “fixed” or “variable.” A fixed-rate mortgage involves a specific interest rate over a fixed period of time, such as a one-, three- or five-year term. “Fixed” (also known as “long-term”) mortgages can have terms as long as 15 years. Generally speaking, the longer the term, the higher the rate. The idea is that you’re willing to pay a slightly higher rate today to have the security of knowing that the interest rate on your mortgage won’t change over the course of your term. For this reason, many first-time homebuyers or those on fixed incomes choose a five-year term to have the comfort of knowing exactly what their mortgage payments will be for the next five years. In exchange, they forego a potentially cheaper mortgage with less security. These long-term mortgages are “closed,” meaning you have a contractual obligation to the lender, and there will be a penalty to get out of this mortgage should you want to break your contract in future.

The alternative to taking a fixed rate would be the “variable-rate” mortgage. These are products that base their pricing off the bank prime rate. Most lenders today offer a discount off prime of roughly half of one per cent. Since the prime rate is typically lower than the prevailing five-year fixed rate, a variable-rate mortgage is almost always less expensive than a five-year fixed rate to start. Why wouldn’t someone take the cheaper “variable-rate” mortgage? Well, the reason it’s called a “variable rate” is because the rate will float with the Bank

of Canada prime rate. If the prime rate goes up, so too does your mortgage. Rather than loosing sleep over the prospect of their largest debt item fluctuating at the mercy of the market, many people prefer to lock in. A significant benefit of a variable-rate mortgage, however, is that you can convert it to a “fixed rate” (meaning, lock it in) at any time with no penalty or cost.

For this reason, variable-rate mortgages have been gaining in popularity. However, most borrowers don’t realize there are two different types of variable-rate mortgages – “open” and “closed.”

An “open variable-rate” mortgage will allow you to break the contract at any time (either pay the mortgage out or switch to a different lender) with no penalty – thus it is called “open.”

The “closed variable mortgage” will typically have a three- or five-year term and cannot be paid out prior to the end of the term without triggering a penalty – typically three month’s interest.

Many new borrowers will gravitate to the idea that they want the freedom and flexibility to be able to pay out their mortgage early, or they misunderstand that the term “variable” is by definition an “open” mortgage, when in fact, it can be open or closed. This is an important distinction because the two mortgage options are priced very differently. An “open variable” mortgage is typically prime plus one per cent, whereas a “closed variable” mortgage is typically prime minus 0.5 per cent. That’s a difference of 1.5 per cent – a significant amount. And when asked why they want to have an “open” mortgage, most clients are not really sure – they have simply confused the terms or are unaware that even if you move before your term is up, you can usually move or “port” your mortgage to your new house.

The bottom line: never pay a premium for a benefit you’ll likely never use.

Peter is the founder of the Peter Kinch Mortgage Team and the PK-Approved group of Dominion Lending Centres mortgage brokers across Canada, and co-owner of the Pacific Bridge Mortgage Investment Corp. Feel free to forward any questions directly to him at pkinch@peterkinch.com

