Breaking up with your mortgage

Variable rates look pretty attractive

Garry Marr, Financial Post
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While not encouraging people to break their mortgages, the banks are acknowledging that some consumers who locked into higher rates can save money if they refinance at the new lower rates.

Anybody who bought their first house in the 1980s must marvel at mortgage rates today. Or perhaps fume.

Another rate cut this past week from the Bank of Canada led all of the major banks to lower their prime lending rate to a new low of 2.5%.

Consumers who locked into variable-rate mortgages tied to prime before credit markets tanked are getting as much as 90 basis points below prime and borrowing as low as 1.6%. It's the deal of the century.

In October, the banks suddenly changed the rules on borrowing and demanded consumers pay a 100-basis premium over prime if they wanted to go variable. The banks have eased up since and the premium on a variable-rate product is 80 basis points above prime for a 3.3% rate.

It poses an obvious question for anyone who has locked into rates as high as 5.75% on a five-year fixed-rate mortgage: Should they break that mortgage?

"It probably does make sense to break it now," says Vince Gaetano, vice-president of Monster Mortgage.

He gives the example of one client who came into his office this past week with a $205,000 mortgage and a 5.24% interest rate. The customer had 3½ years left on a five-year mortgage. The penalty to break his mortgage is the greater of three months interest or what is called the interest rate differential. The interest rate differential is the lost interest between your current rate and market rates.

In that client's case, his interest rate penalty is calculated based on the current four-year rate at his bank, now 4.14% on a discounted basis. The lost interest to the bank is about $7,800, which is what the customer will have to pay.

It's a big penalty but Mr. Gaetano argues that if that same customer breaks his mortgage and goes with the variable-rate mortgage at 3.3%, the savings would be in the $13,000 to $14,000 range over 3½ years -- more than offsetting the penalty.

There is also a nifty little trick you can pull off if you have a prepayment option on your mortgage. Mr. Gaetano's customer has a 25% prepayment privilege, so he can knock $57,000 off his mortgage and lower his penalty by about $2,800.

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"To me, it's pure mathematics. There is nothing speculative or probabilistic about the decision to break a mortgage. It is the classic example of undergraduate finance time-value-of-money calculations. If the homeowner can refinance into a mortgage with an identical term that reduces monthly payments above and beyond any penalty costs, then go for it. Plain and simple," says Mr. Milevsky.

Breaking your mortgage based on a decision to go into a variable-rate mortgage is an entirely different decision.

"This decision shouldn't be confused or muddled with the classic long or short decision, or whether real estate prices or interest rates are headed up or down from here," he says.

So, it comes down to two choices: The first is to break your locked-in mortgage and renew for another fixed term. If it saves you cash, that is a no-brainer.

The second choice is whether to switch products and go with a variable-rate mortgage. Historically, consumers have saved money 88% of the time going variable, according to Mr. Milevsky's own studies.

I'm still in the camp that favours a variable rate.

Dusty Wallet This will not save you any money, but if you are strapped for cash because one of the breadwinners in your home has lost a job, the banks will let you lengthen your amortization period. If you have a 25-year amortization you can lengthen it to 35 years without any service charges -- other than the huge jump in interest charges!

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