

# Go with the Float?

Fixed-rate mortgages offer piece of mind, but not much else **BY MOSHE ARYE MILEVSKY**

**M**y wife has finally convinced me it's time to buy a house. We agreed that she will find the house, while I arrange the financing. At first, I thought my job was the easier one, but with the numerous mortgage choices, I'm starting to regret the division of labour.

My biggest dilemma: Should I take a fixed- or floating-rate mortgage? With a fixed-rate mortgage, monthly payments are predetermined and set for the entire term of the mortgage. In contrast, floating-rate mortgage payments change month to month, and are usually linked to the prime lending rate.

In February, floating rates were at 7.25%, while five-year fixed-rates were close to 7.5%. Naturally, many people choose a higher fixed-rate mortgage to protect themselves against the risk that rates will increase over the next few years. This protection is akin to insurance, and you do pay for it.

To get a sense of how much this insurance costs you in the long run, I conducted a hypothetical experiment, using historical fixed and floating rates. Imagine two people, Linda Long and Shelley Short. Each of them is about to renew her mortgage, both of which have an outstanding value of \$100,000. They intend to amortize their payments over 15 years. Linda Long has decided to refinance her mortgage at the five-year fixed rate, while Shelley Short is going with the floating rate.



Linda will make fixed payments and renew her mortgage every five years. In five and 10 years, her new payments may be higher or lower than her current rate, depending on interest rates at that time. Shelley, on the other hand, will link her mortgage to prime, and her payment could change monthly. But both will pay off the mortgage in exactly 15 years.

I also simulated the total amount of interest paid had Shelley and Linda implemented this strategy at any time during the last 50 years. For each month, I subtracted Shelley's payment from Linda's. This represents savings from going short versus long in any given month, and may be negative if floating rates are higher than fixed at a particular time. I added these savings together and computed their total value (including interest) at the time the mortgage was completely paid off (see chart.)

For example, in January 1980, the prime rate was at 15%, while the five-year rate was at 13.25%. Thus, Shelley's first payment was higher than Linda's. But by the time Linda renewed her mortgage in January 1985, the fixed rate was at 12.25%, while prime was at 11%, meaning Shelley's payments were lower, and by the time both had paid off their mortgages, Shelley had saved over \$30,000 in cumulative interest payments. By analysing all possible combinations during the last 50 years, I found an average savings for Shelley of \$22,210. And, in 85% of the cases, Shelley saved at least \$10,000.

In sum, if your budget can handle fluctuating payments — and you can handle the stress — chances are the floating rate will save you money. I'm certainly willing to take the chance. **B**

In 1999, 53% of homeowners were carrying a mortgage, up from 51% just two years earlier.

## TO THE RISK-TAKERS GO THE REWARDS

The cumulative interest saved/lost by the end of a 15-year floating-rate mortgage, compared to the fixed rate, by month the mortgage was paid off

